PRESIDENT CLINTON'S COMMUNITY REINVESTMENT ACT PROPOSAL

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

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TUESDAY, FEBRUARY 8, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Joseph P. Kennedy II [chairman of the subcommittee] presiding.

Present: Chairman Kennedy, Representatives LaRocco, Rush, Roybal-Allard, Velazquez, Wynn, Watt, Hinchey, McCandless, Knollenberg, Bereuter, Thomas, and Bachus.

Mr. LAROCCO [presiding]. The purpose of the hearing is to investigate the administration's community reinvestment proposals. Chairman Kennedy has been held up on a flight. He should be here shortly from Boston, but we want to move ahead. As I understand it, there are transportation problems throughout our region here.

I don't have an opening statement this morning. I will turn to Mr. McCandless. And let me say, as a colleague of Mr. McCandless, I want to note his recent announcement of plans to leave this distinguished body and to express my thanks for the work that we have done together.

I turn to him for an opening statement.

Mr. MCCANDLESS. Thank you, Mr. Chairman. I don't want to take any of your time because it is important that we hear from these gentlemen. I am interested in hearing from these witnesses their assessment of the President's initiative. I want to hear the strengths and weaknesses of these proposed regulations.

Basically, I am interested in hearing whether banks and communities would be better off under this proposal or under the current regulations. I encourage the witnesses to be candid and to talk about the specific issues that they feel are most needed in this discussion.

I want to remind our witnesses that their written testimony will be included in the record. I want to welcome the witnesses and look forward to their testimony.

Thank you, Mr. Chairman.

Mr. LAROCCO. Thank you, Mr. McCandless.

Mr. Thomas.

Mr. THOMAS. Thank you. I come from Wyoming where most of the banks are small. I want to note that there is special recognition of small banks. You would be surprised how much time we spend, whether it is bank regulators or educators whatever, trying to

make things that are done here fit in Jackson, Wyoming, where the banker has been asked to have a full-time person to do the paperwork in a small bank for community reinvestment.

I am pleased that we are doing that.

I hope that you will comment on the 60 percent loan question which raises questions in the minds of many of us, and perhaps examine for us a little bit the merit of having some kind of a flexible one, where the average—or where you were compared to your peers in terms of loan ratios.

Obviously, if too much paperwork is involved in this, if we could find a way to reduce that, I hope we can do that.

I look forward to your testimony.

Mr. LaRocco. Mr. Knollenberg.

Mr. Knollenberg. Thank you, Mr. Chairman.

I recall some of you back as repeat witnesses. I look forward to the testimony. And while I wholeheartedly support the idea of expanding capital access in the traditionally underserved areas, I do have some general questions or concerns about the CRA proposal in question.

It seems to me that the proposal subtly changes the proposal and the basis of a CRA rating for banks, and the results do concern me. And while this may seem like a change that is prudent on the surface, on the face, I am concerned that the act might act as an incentive for banks to engage in unsafe lending practices to simply improve their rating.

Our first responsibility is to protect the taxpayer at large in any kind of financial instability.

So with that in mind, I look forward to your testimony; and I appreciate the opportunity to make the statement.

Thank you, Mr. Chairman.

Mr. LaRocco. Thank you.

We have a long morning ahead of us, and the first panel is seated before us. I remind all witnesses that the members of the subcommittee received copies of your full statements. And if you could summarize, that would be helpful to us, hopefully within 5 minutes.

We will start with the Honorable Eugene A. Ludwig, Comptroller of the Currency. He has been an energetic and welcome new voice in the administration. He has made a commitment to improve the Community Reinvestment Act, which is long overdue.

We express our appreciation to you for joining us today and please proceed with your testimony.

STATEMENT OF EUGENE A. LUDWIG, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. Ludwig. I am honored to be here. I appreciate this opportunity to discuss the proposal published for public comment by the four Federal banking agencies to reform the Community Reinvestment Act regulation. I have a detailed written statement that describes the proposal. In the interest of time, I would also like the statement submitted for the record. I would like to submit for the record the text of an address on CRA that I delivered yesterday to the National Community Reinvestment Coalition.

Mr. LAROCCO. Without objection, they will be entered into the record.

[The information referred to can be found in the appendix.]

Mr. LUDWIG. To me, Mr. Chairman, community reinvestment is not some vague abstraction. I know, not from analysis but from personal experience, how important credit can be in the life of a community and in the lives of individuals.

My father was the son of an immigrant and a son of the Great Depression. My father wanted to be a country doctor. Without bank credit, achieving this dream would have been impossible. Bank credit permitted him to fulfill his dream and go on to serve the community of York, Pennsylvania, through a free medical clinic and in many other ways over a period of 60 years.

My father's dream, the dream of a better life for his family and of contributing to his community, is an American dream—one fulfilled by the fathers and grandfathers of many people in this room. Tens of millions of Americans today, affluent and poor, have a similar dream.

In our market economy, access to credit determines whether many, perhaps most, people can fulfill their dreams of a better life—whether they can go to school, whether they can start a business. Credit alone may not be sufficient to turn millions of American dreams into reality, but it is necessary for that to happen. For small business owners in particular, access to credit often means the difference between having a great idea and a grand opening—between having a going concern or a going-out-of-business sale.

I know you understand this, Mr. Chairman—you have been a fighter for equal access to credit, and the availability of credit, so that our people can fulfill their dreams and contribute to their communities. I know you appreciate how important it is to reform CRA so that it can fulfill its promise.

President Clinton understands the critical need for CRA reform. During the 1992 Presidential campaign, he had heard strong complaints from bankers and community leaders that CRA had fallen short of its promise—that it was administered through a regulatory framework that emphasized process over results. Rather than making loans, the current system directed banks to produce mounds of useless paperwork that documents meetings and board actions and telephone calls.

Last July, the President instructed the banking regulators to reform the CRA process so that it would work as it was intended. President Clinton told us he wanted results. He challenged us to reform CRA so that we would have a system that would evaluate banks on what they did, not what they said.

As you know, from the very beginning of the reform process, we regulators have been dedicated to a painstaking process of consultation and deliberation so the final product would be right. Before we made a single decision on reform, we turned to the public for direction.

We held a series of hearings throughout the country—hearings in Washington, Los Angeles, San Antonio, Albuquerque, Chicago, New York City, and Henderson, North Carolina—the most extensive series of hearings ever held on CRA. In these hearings, the heads of the OCC, the Office of Thrift Supervision, and the Federal

Deposit Insurance Corporation and Federal Reserve Governor Lindsey heard more than 250 witnesses. We recorded thousands of pages of testimony. We walked through south central Los Angeles and low-income neighborhoods in New York to see with our own eyes and to listen with our own ears to what should be done. We talked with representatives of the Navajo Nation, to bankers, large and small, to poor people in rural America. What we have heard and what we learned both corroborated what the President had heard and shaped the reform package we proposed. Virtually every witness strongly criticized the current system. They complained that the current system was subjective and that it focused on effort and not on results. Most witnesses wanted results. Community groups, as well as individuals, wanted credit, services, and investments. Banks, especially small banks, wanted relief from useless regulatory burden.

My point in describing our deliberative process, Mr. Chairman, is simple. Far from avoiding comment on CRA reform, we have, from the very beginning, sought it out. And, we are still seeking it out. We welcome it. That was one reason that we extended the comment period on our proposal. We want to encourage public participation and meaningful analysis because both will benefit reform.

The comment so far has been constructive, and we anticipate receiving more constructive comment. We want to do it right, and so we are willing to take the time and to make the effort to do it right. If our proposal were perfect, we would not have had to put it out for public comment. Public comment is intended to be a stress test that will reveal flaws and imperfections. Public comment is just as essential to perfecting the proposal as our public hearings were to developing it.

Mr. Chairman, we will be just as attentive to how we implement the final rule, to writing detailed examination procedures, and to training our examiners as we were to developing the proposal. We are dedicated to making CRA reform work in practice as well as in theory. Along the way we will have to address a host of managerial problems: How to provide the most effective examination training; what specific procedures the examiners will use to evaluate small banks; how to evaluate bank-generated CRA plans. In this way, our CRA proposal is not unlike other regulatory initiatives—setting broad outlines and goals first. We will then fill in the details.

We will get the job done. And we will get it done expeditiously. Just as our proposal is aggressive, the final product will be aggressive. It will aggressively address the real problems of real people who are now underserved, or unserved, in communities throughout the country.

Thank you, Mr. Chairman. I look forward to answering your questions.

Mr. LAROCCO. Thank you, Mr. Ludwig.

[The prepared statement of Mr. Ludwig can be found in the appendix.]

Mr. LAROCCO. The next witness is the Honorable Lawrence D. Lindsey. He is a member of the Board of Governors of the Federal Reserve System. He served as Special Assistant to the President

for Policy Development from 1990 to 1991 at the White House as Associate Director for the Economic Policy from 1989 to 1990.

Thank you for being here today, and I am looking forward to your testimony.

STATEMENT OF LAWRENCE B. LINDSEY, GOVERNOR, FEDERAL RESERVE BOARD OF GOVERNORS

Mr. LINDSEY. Thank you. I appreciate the opportunity to appear before this subcommittee to discuss CRA reform.

The Community Reinvestment Act is intended to ensure that every community has access to adequate credit to help meet its needs.

We at the Federal Reserve Board believe that the law has produced substantial benefits; however, the CRA has not, nor should it have been expected to have, cured all the problems that plague our cities.

I have joined with my colleagues in an effort to reform CRA by amending our regulations. This effort is the result of the President's request to make CRA more objective, the ratings more uniform, and the paperwork less burdensome.

The effort is a challenging one. It involves a substantial commitment by the agencies and encompasses many different issues. We are very conscious of the fact that what we do could significantly affect both financial institutions and the public, and that care must be exercised when undertaking such an important project.

Now, as we are midway in the process and still receiving comments from the public, today our comments will necessarily be somewhat preliminary.

In the course of our review of CRA, we have heard from many consumer and community groups about how valuable the law has been in getting credit extended to low- and moderate-income areas. Some groups put the success of CRA at $30 billion, which they estimate to be the level of CRA commitments for new credit. This has occurred with a comparatively light hand from Washington.

Indeed, one of the strengths of the present system is that it allows great flexibility in fashioning programs to meet the differing and changing credit needs of this country's divergent needs of communities.

I have submitted a written statement. I would like to focus on one important point. We developed the proposed changes to our CRA regulations in conjunction with the other agencies. During the comment period, I am paying particular attention to questions or complaints about the details of implementation and of potential unintended consequences from how the proposal will work in practice.

I am committed to making sure that the regulation we finally adopt will work. We will do no one any favors by promulgating a rule that is operationally untenable. I would like to turn to some specific issues that have been raised by my colleagues and by members of this subcommittee in inviting us here.

First, the proposal is intended to provide greater certainty to institutions in the type of evaluation they might expect to receive, primarily based on their performance relative to others.

Some have noted that measuring an institution's performance against other lenders in the service area yearend means that the standards necessarily will be fluid from year to year.

Moreover, some have noted that the terms used to describe different levels of performance, such as "roughly comparable," "significant amount," and similar words are anything but precise.

These general standards were proposed, in part, to reflect the diversity of America, its inner cities, and its many credit markets.

Still, institutions may have to speculate about the activities of their competitors. And examiners will be forced to interpret these terms on a case-by-case basis when evaluating institutions.

To some extent, we will always be plagued by the dilemma of how to provide better guidance and certainty in CRA without reducing needed flexibility.

The second concern involves the new data collection requirements. It is important to the goal of making the CRA process more quantifiable, yet data collection could be very costly. For covered commercial banks, the annual cost of the small business portion of the data collection alone could approach $21 million.

In all, about 4,400 institutions will be required to gather new data. I think it is, therefore, a legitimate question whether it is desirable to impose this burden since so much subjectivity necessarily is also part of the new system.

The third question involves the appropriateness of the streamlined review procedure for small institutions under $250 million in assets—we have gotten many comments on this—as well as the impact of the presumption that such small institutions will have a reasonable loan-to-deposit ratio if it is 60 percent.

We have heard from a number of small banks who have commented on the proposal that this is unrealistically high and rigid, and we have some concerns that some institutions that want to benefit from the streamlined CRA review might be forced imprudently to change their lending standards in order to meet this presumption.

The other controversial aspects of our proposal, such as whether the alternative evaluation plan for banks is workable, whether the role of the public in community groups in the development of the plans is adequate, and whether we in fact should be treating institutions receiving low ratings as being in violation of the regulation, I believe, will receive considerable attention from the public.

In the letter of invitation, a number of other questions were raised. The first has to do with the appeals process. Financial institutions have always been able to request supervisory personnel at Reserve banks to review the ratings issued by examiners, whether involving CRA or other supervisory issues. But we do not consider this a formal appeals process.

We anticipate that our informal system would complement the opportunities for input in CRA evaluations. The proposal would permit institutions to rebut presumptive ratings under the lending, service, and investment tests. But the proposal also provides that the agencies would announce upcoming examinations in order to get public comment on an institution's performance. These comments, and those in the institution's public file, would be taken *into great account* in our assessment of their performance.

The second question raised in the letter of invitation involves the frequency of examinations for institutions rated outstanding. The proposal doesn't address examination frequency. Our current policy, however, does allow evaluations to be conducted less frequently for institutions with outstanding ratings.

Presently, State member banks rated outstanding with at least satisfactory ratings on consumer compliance in general are examined once every 18 to 24 months compared to a 6- to 12-month examination frequency for poor performers.

At this time, I would assume that we would maintain our current policy even with the regulatory changes.

The third question involved the effect of investment credits and indirect lending on ratings. Under the proposal, investment activity by retail banks could help to increase their base rating in the lending test up two levels if the investment performance is outstanding. Investments will be the sole criteria for measuring the performance of wholesale and limited purpose banks, however. Indirect lending activity may be taken into account under either the lending or investment tests.

These aspects of the proposal are controversial and of particular concern to community groups. We will be evaluating their comments very carefully as we consider what the appropriate treatment of investment and indirect lending should be.

The next question raised in the letter involved the effect of ratings and public involvement on applications. CRA ratings, as well as public comments, on applications can and do influence significantly the Board's consideration of an institution's application. This has been made clear in earlier CRA policy statements.

The proposal is more explicit than our current regulation about the effect of different ratings and what effect that will have on the Board's consideration. For example, under the proposal, an outstanding would be looked on very favorably; and a substantial noncompliance rating generally would result in a denial of an application. We are aware that there may be an implicit safe harbor in the proposal. That was not intended; and to the extent that there is any misunderstanding, it will be clarified in the final version.

In conclusion, Mr. Chairman, we have been afforded a unique opportunity to step back and take a fresh look at the enforcement of one of the most important, yet controversial, laws affecting financial institutions.

In proposing the comprehensive regulatory reform of CRA, we have been highly aggressive in our approach; and our efforts are bound to generate a good deal of debate and concern. Although I take some natural pride in authorship, given the time that I have invested along with my colleagues, I am not inalterably wedded to this proposal.

If the public comments pointed out serious flaws, particularly in the area of operations or implementation, or if better ideas emerge, I am perfectly willing to recommend to my fellow regulators and members of the Board of Governors that we return to the drawing board. We should not hesitate to do so if that is the way to ensure that we have done the best job possible. To give the public anything less than the best is a goal that no one involved in this process should condone.

Thank you, Mr. Chairman.

Mr. LAROCCO. Thank you.

[The prepared statement of Mr. Lindsey can be found in the appendix.]

Mr. LAROCCO. I would like to note the arrival of a few of my colleagues: Mr. King, Mr. Kinder, and Mr. Bereuter and Congresswoman Roybal-Allard and Congresswoman Velazquez and Mr. Watt.

And if any of those members would like to enter an opening statement into the record at this time, without objection, so ordered.

And—OK. Thank you very much.

Our next witness is the Honorable Andrew C. Hove, Jr. He is the current Acting Chairman of the Federal Deposit Insurance Corporation. He was the chairman and chief executive officer at Mendon Exchange Bank & Trust Co., in Nebraska before joining the FDIC.

We would like to express our appreciation to you, and please proceed.

STATEMENT OF ANDREW C. HOVE, JR., ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. HOVE. Thank you, Mr. Chairman and members of the subcommittee.

On behalf of the Federal Deposit Insurance Corporation, I welcome this opportunity to testify on the proposal to reform the regulations that implement the Community Reinvestment Act.

In July of last year, President Clinton requested that the agencies undertake sweeping reform of CRA regulations. After consultation with depository institutions, community organizations, and others throughout the country, the agencies under the leadership of Comptroller Ludwig, drafted a proposal to reform regulations implementing CRA. That proposal is now out for comment until March 24.

I think there is general agreement that we can improve upon the way we implement the CRA. In public hearings across the country, there was a common message that not enough attention was being placed on whether loans are being made and services are being provided. Banks and thrifts are not satisfied with the current regulations and procedures because they focus too much on the process and documentation. Individuals and community organizations also feel that more emphasis needs to be placed on results but that we need more data to confirm that institutions are producing those results.

The proposed CRA regulation issued by the banking agencies is intended to focus our efforts on results. Institutions will be evaluated based on their performance in the areas of lending, investment, and the provision of services. Small institutions will have a streamlined examination process; but, here too, the focus will be on results.

I would like to turn to some of the issues that the subcommittee requested we address in our testimony. A detailed discussion of all the issues outlined in your letter of invitation is included in my written testimony.

An issue of particular importance to the FDIC is the provision allowing small institutions the option of a streamlined assessment method. As the regulatory agency responsible for supervising approximately 65 percent of the institutions under $250 million in total assets, the FDIC would like to make it clear that the proposed streamlined assessment method will not constitute an exemption for these small institutions.

As stated in the proposal, the agencies do not believe that an exemption is permitted by the statute. Furthermore, we believe that an exemption would be unwise because it may result in the neglect of credit needs of some communities that are served by small institutions.

Under the proposed streamlined method, examinations will not become mere formalities or simple reviews in which examiners quickly determine whether the institutions have met the items on a checklist. Examiners will be required to determine if an institution has a reasonable loan-to-deposit ratio, makes the majority of its loans locally, and makes a variety of loans across all income levels.

In addition, if the institution is required to report loans under the Home Mortgage Disclosure Act, the institution will be required to have a reasonable geographic distribution of reported loans. Examiners also will consider whether or not an institution has engaged in illegal lending discrimination.

We are very interested in comments on whether these standards for small institutions are addressed in a way that will allow us to take into account differences in the size and capabilities of institutions while also taking into account the varying needs of their communities.

With respect to larger institutions, in order to evaluate the results of their lending efforts, an examiner must know something about the types of loans the lender originates, how many, in what amount, and where. The proposal will require the collection of loan data to measure these results. Large institutions with more than $250 million in total assets will be required to report information on the geographic distribution of certain consumer loans, small business loans, and small farm loans. We will study comments on the costs and feasibility of this approach.

Finally, the proposal allows an institution the option of submitting for agency approval a strategic plan as an alternative to being rated after the fact under the lending, service, and investment tests or the small basic assessment method. The strategic plan will detail how the institution proposes to meet its CRA obligation using measurable goals.

Notice of the proposed plan will be widely published by the institution. This will allow community groups and others an opportunity to review the plan and provide the agency with comments prior to approval. Again we will be interested in the comments on this aspect of the proposal.

So how will the FDIC implement these changes? Since 1990, the FDIC has undertaken a series of important initiatives to expand our capability and improve fair lending compliance. Many of these steps will be helpful in implementing the new CRA regulations.

These include the formation of a separate Compliance Examination Program within our Division of Supervision and Community Affairs Program within our Office of Consumer Affairs.

An Assistant Regional Director in each of our eight regions in the Division of Supervision is now dedicated solely to the management of the compliance and fair lending function. Until now, Assistant Regional Directors who managed this function had additional responsibilities. There are now approximately 300 compliance examiner positions at the FDIC compared to 150 when the separate Compliance Examination Program was first implemented in early 1991. More will be added as necessary.

Each region maintains a separate Compliance Examination Review staff with specific responsibility for the compliance and fair lending examination function.

We have improved examiner training and increased communication with depository institutions, community organizations, and other agencies.

Further, we have improved our examinations tools. For example, the HMDA Analysis Reports, customized for each institution and specific geographic areas, are being provided for examiners and tables summarizing an institution's reported HMDA data were recently installed on easily accessible computer networks in each region.

Recently, we began a HMDA Disparities Investigation project to review racial and ethnic disparities in denial and application rates reflected by the 1992 HMDA data reported by FDIC-supervised institutions nationwide.

Extensive review procedures have been set out to ensure that all institutions with high denial rates for minorities will undergo a review to discover the reasons for the disparities and identify those institutions exhibiting possible illegal discriminatory behavior.

In conclusion, the FDIC believes that strong, fair lending actions by the banking industry, supervision by its regulators, and partnership efforts with community groups and individuals are critically important to making the Community Reinvestment Act work.

We are mindful of our responsibility to promote safe and sound banking and of the recognition in the Community Reinvestment Act that depository institutions have an obligation to help meet the credit needs of their entire communities, including low- and moderate-income communities.

We believe that both of these goals are attainable. While the proposed CRA regulation is not perfect, we believe it represents a significant step in reaching these goals. We will carefully evaluate all of the comments received and expect to further refine the proposal.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Hove can be found in the appendix.]

Mr. LAROCCO. I want to note the arrival of Mr. Rush and Mr. Wynn and make the opportunity available to enter a written statement into the record if you so desire at this time.

Mr. RUSH. Thank you, Mr. Chairman.

Mr. LAROCCO. Without objection, so ordered.

[The prepared statement of Mr. Rush can be found in the appendix.]

Mr. LAROCCO. And, Mr. Wynn.
Mr. WYNN. I will submit one.
Mr. LAROCCO. Thank you.
Our next witness, and the final one of the panel, is the Honorable Jonathan Fiechter.
He has been the Acting Director of the Office of Thrift Supervision since 1992. He served as Director of the FDIC, the Thrift Depository Protection Oversight Board, and the Neighborhood Reinvestment Board. He served as Deputy Comptroller at the Office of the Comptroller of the Currency for 10 years.
We look forward to your testimony.

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FIECHTER. Thank you, Mr. Chairman and members of the subcommittee. I appreciate the invitation to appear today.
My written testimony outlines the President's CRA initiative, discusses the agencies' proposed CRA regulation, and responds to the questions posed in the letter of invitation.
I would like to use my time this morning to discuss three issues that are relevant to our regulatory reform efforts and the overall effectiveness of the CRA.
At the outset, I want to assure the subcommittee that OTS fully supports the effort to revitalize our communities through reinvestment.
I believe that credit can be used as an engine for economic growth and revitalization. To succeed in this effort, communities, financial institutions, and government need to form partnerships and work together to make credit and financial opportunities available to people in all walks of life and in all communities.
At the same time, the Federal Government needs to reduce any unnecessary regulatory roadblocks or burdens on financial institutions.
The agencies' proposed CRA regulation focuses more on performance and less on process. It also attempts to provide clearer standards of what is expected. If we are successful, the result will be an approach that will more effectively generate lending services and investments in our communities.
Solving the problems of depressed and underserved areas of the country requires the coordinated efforts of government, industry, and private citizens, all acting in partnership with a common goal. This partnership is the first issue I would like to discuss.
If we are to successfully increase the flow of credit to areas of need in our country, we must make certain that we are doing all that we can at the Federal level to reduce any unnecessary barriers to safe and sound lending.
We also need to ensure that the various Federal, State, and local government programs are coordinated and accessible to all institutions and the public.
There are a number of State and Federal programs available to assist an institution that wants to develop a neighborhood or block in its community.

But there is no one place that an institution can go to find out how to access these programs and services. Moreover, the programs themselves may not be compatible.

OTS has begun to address part of this market inefficiency in our affordable housing initiative announced last spring. We are committed to encouraging safe and sound lending for affordable housing by examining and removing any regulatory or programmatic barriers to such lending and by providing education and support services to institutions that are interested in doing more affordable housing lending. We are also pleased to see the establishment of the President's Fair Housing Council and look forward to participating on that group.

I believe that focusing on community reinvestment in a cooperative manner and eliminating as many market inefficiencies as possible will stimulate more community lending in the long term.

The second issue I would like to discuss involves the coverage of CRA in general and the role of thrift institutions in particular.

The thrift industry is making progress in contributing to community reinvestment through the provision of credit and basic financial services.

A comparison of the 1992 HMDA data with the 1990 and 1991 data suggests that the thrift industry is increasing the proportion of total loans going to low- and moderate-income applicants.

On the other hand, the thrift industry is also much smaller than it was a few years ago. Thrifts' market share of 1- to 4-family mortgages has dropped from 38 percent to 18 percent in the last 5 years.

As a result, improvements in the performance of the thrift industry will have a much smaller effect on the overall objective of promoting community development.

One of my personal goals during this reform process is to dispel any concerns that savings associations may have that compliance with the CRA jeopardizes safe and sound lending. That is simply not true; and, in particular, the 60 percent loan-to-deposit standard jeopardizes safe and sound lending, that is simply not true.

In fact, the proposed regulation recognizes that an institution's CRA obligation must be met using prudent business practices. The proposal doesn't encourage or expect a liberalization of underwriting standards to the detriment of safe and sound lending principles.

On the other hand, it does encourage institutions to be innovative in attempting to create products to meet the various needs of a diverse customer base. Lending to low- and moderate-income households and businesses can be good business for both the institution and the local community if done properly. It strengthens ties between the institution and the community. Frequently, these loans are made to the fabric of the community: The school teachers, local municipal workers, and households dependent on retirement income.

In conclusion, the interagency proposal is a significant departure from the way in which the CRA has been administered in the past. As a result, we expect substantial public comment.

We would be pleased to share what we learn from these comments with the subcommittee as the regulatory process continues.

Again, I would like to thank you, Mr. Chairman, for your invitation and your continuing interest in our reform efforts.

I will be pleased to respond to any questions that you may have.

[The prepared statement of Mr. Fiechter can be found in the appendix.]

Mr. LAROCCO. Thank you, very much. And I will begin the questioning to you Mr. Ludwig.

In 1992, 9,000 institutions were examined; 87 failed. That is 87, not 87 percent. Eighty-nine percent got satisfactory or better.

My question is: How will these numbers change as your proposal is implemented? And what are your projections? Do you have some?

Mr. LUDWIG. We don't know precisely how those numbers will change. We do know that we will be looking at what the institutions are actually doing. And we will be able to evaluate in a way that is credible to the public and credible to the agencies.

One of the problems with the current system—and I have read dozens and dozens of exam reports—is that if you evaluate on the basis of how many meetings a bank has, how many telephone calls they make, and whether they report to the Board or not, you cannot come up with a credible report that community groups, bankers, or regulators have confidence in as properly evaluating the institution.

I remember a small institution in New Mexico that, by any standards, is doing an outstanding job. They had begun inner-city efforts in their small town a year before CRA, and they were in a county that was well below the national median in terms of income. Yet, that institution barely got a satisfactory rating, let alone an outstanding, because it had not produced its pile of papers, irrespective of the amount of lending it was doing.

The new proposal would make judgments on the basis of what banks are doing. In the end, I think most institutions in this country will work very hard to get satisfactory or outstanding ratings. And, we will see a preponderance of institutions in the satisfactory column. But in terms of absolute numbers, I can't give them to you.

Mr. LAROCCO. Do any other members have a projection in mind if the——

Mr. LINDSEY. I agree completely with the Comptroller, there is no way to project at this time.

Mr. HOVE. I would agree. I guess the goal is to get 100 percent of institutions rated satisfactory or better. That is the goal—to make sure that there is an effort by all banks to do the right kind of job.

Obviously, we are not going to get that. But it is a little hard at this time to know what kind of numbers we are going to get.

Mr. FIECHTER. This is a different standard than the one that we are applying.

Mr. LAROCCO. Last week the Financial Institutions Subcommittee approved legislation on interstate branching, banking, and consolidation. Are there special CRA issues for interstate banks?

The interstate issue has been referred to this subcommittee. What should we say about it from a CRA perspective?

Mr. LUDWIG. The CRA reform proposal takes into account banks that have broad geographic areas whether within a State or across

State lines. It would evaluate banks on the basis of their service areas, where they do their lending, regardless of whether they are across State lines or they are spread across a very large State. So the proposal contemplates evaluation of an interstate institution.

Chairman KENNEDY. Excuse me.

First of all, let me just say thank you to Mr. LaRocco. I have been circling this great city for the last 1½ hours. So it is good to be finally on the ground.

I want to just say very briefly that, although I haven't had a chance to see the ranking member since he made his announcement some time ago that he was not going to be seeking reelection, I just wanted to say, Al, that despite the fact that I don't know if I could come up with a single issue we ever agreed on, I nevertheless am going to miss you. I want to mention what a real pleasure it has been to work with you over the course of the last 8 years, that you have always spoken out very forthrightly about your beliefs about the policies that we have taken up in this subcommittee and have been a bellwether that many people could get a handle on our positions based on your positions.

So I do, in all honesty, want to say that I think you have contributed a tremendous amount to our country. Also, that despite the fact that we don't agree, the honorable efforts that you have made on behalf of people that you have believed in have really made a difference for our country. I want to say what a pleasure it has been to work with you.

I want to continue to work with you over the course of the next year. I want to let you know that, above all else, I consider you a friend and a colleague and someone that I will miss working with.

So thank you for your efforts, and best of luck in the future.

Mr. MCCANDLESS. Thank you, Joe. Flattery will get you everywhere.

Chairman KENNEDY. Mr. McCandless, you have as much time as you may consume in the next 5 minutes.

Mr. MCCANDLESS. How high was that plane? Was air coming through some of the windows?

Let me ask the panel a couple of basic questions.

We still have the OCC, the Federals, the FDIC, and the Securities and Exchange Commission doing some type of regulatory examining process in most of our institutions.

Now we are talking about changing this program; and, in a sense, we are saying that we are going to broaden the examiners' role. And if I understand correctly, that role will be extended to the section of the Code which deals with all aspects of banking as it relates to administration rather than the limited narrow area currently in which the examiner performs.

To the extent that an examiner, under this proposal, given its passage, could close a bank because it didn't comply based upon the section that would apply here, 12 U.S.C. 1818.

Now we have four examiners. They all have a certain authority over a little bank. For example, one where they have 10 to 13 people on the staff, and 1 spends full-time doing nothing but paperwork to satisfy current regulations.

With respect to the examiners, are we going to have four separate report cards from four separate institutions based upon four

separate observations as to whether this institution being examined is satisfactory, unsatisfactory, whatever?

Where can we standardize what is necessary in the way of proper examiner oversight yet have consistency from which, then, the management of that bank can grasp and move in terms of policy?

Mr. Lindsey.

Mr. LINDSEY. I think your point is well taken, Mr. McCandless. And I think that one of the tasks we have is to have greater consistency in our examination process.

Right now, regarding CRA at any given institution, there is one and only one examiner. So, for example, when we at the Fed contemplate a merger application, we have before us, often, an examine that the OCC has written. I think that greater standardization of procedures among the agencies is also an important part of this. And we will work toward that.

Mr. MCCANDLESS. Let me drop a little tidbit here for your benefit. Back in the previous major legislation in 1990, there was to be a section 6 in which we would have a bank examination system for all agencies. The Feds were inalterably opposed to this. And as a result, they prevailed.

Given the proposal that we have before us, wouldn't, in your opinion, there need to be a review, a revisiting of the subject for purposes of examining and standardization?

Mr. LINDSEY. Well, I think that the FFIEC and all other efforts on this issue are to standardize the product.

Again, there would be one examiner in any given institution. There is under current practice. So, I must say, I have no doubt that we can do a better job; but I am not sure the point of the question.

Mr. MCCANDLESS. Mr. Ludwig.

Mr. LUDWIG. Yes, sir. This is precisely why I favor consolidation of the Federal banking regulatory apparatus. We will do our best to coordinate our efforts, but inconsistencies are bound to arise when you have four different agencies. Nonetheless, working together with these gentlemen around the country in developing this proposal, I am confident that we can administer the current system in a way that can be reasonable. But I agree with your comment. We are much better off if we have a consistent, single voice in these matters.

Mr. MCCANDLESS. Mr. Fiechter, GAO has concern about this proposal in that it may create disincentives for institutions not already located in low- and moderate-income areas to move into these areas.

What comment would have you about that?

Mr. FIECHTER. I think, as I understand the GAO report, it has to do with the lending test. I think that we will be able, in our proposal as we develop it, to make certain that an institution that makes a few loans in one area and, as a consequence, in one respect doesn't do well because it has such a small market share, will not be penalized.

Clearly, the objective of the proposal is to encourage more institutions to come into these areas and lend. I am pretty confident that we can address the problem that the GAO has brought up.

Chairman KENNEDY. Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman.

Mr. Ludwig, with regard to the market share test, if a lender is doing only a small number of small business loans in wealthy areas, is it in your opinion that there is a danger that even if there is a strong need for business loans in low-income communities that the lender is under no real obligations and possibly could be given a satisfactory rating based on the loans in the wealthy community?

Mr. LUDWIG. Congressman Rush, the market share test is really more of a screen. It is a rebuttable presumption. That is, even if a bank passed it, the agency might find that its performance was unsatisfactory. And, indeed, the test itself is not just made on the basis of market share but also on whether there is substantial lending and whether a bank is lending in a preponderance of its low- and moderate-income census tracts. So it is much more complex than whether you have equivalent market share.

What we attempted to do was to fashion a screen that is not an absolute test or a bright line but is intended to give guidance. But the real test is more complex than that. It is what a bank is actually doing. For example, it includes a number of different aspects. Are the projects innovative? Is a bank doing this in a preponderance of its low- and moderate-income census tracts? Are the loans it is making substantial in comparison to its size and other institutions?

So we clearly have not explained this well. Moreover, there has been a lot of comment, and we expect a lot of comment on it. But it was not meant to be a bright line test.

Mr. RUSH. I am concerned about some of the ambiguity in certain portions of this particular act, ambiguity as it relates to examiners who can interpret and apply such words as "significant," "roughly comparable," "very significant percentages," "significantly less," "insignificant percentages."

How do you intend to make sure that the examiners receive sufficient training so that they can have more of an intimate understanding of what community development is all about and what the goals and objectives of those of us who are concerned about community development and those of you who have a distinct responsibility to make sure that CRA is implemented in the spirit that it was written?

How do you intend to train and educate and upgrade the understanding of the examiners, especially in light of the fact that they have these ambiguous terms that they can utilize?

Mr. LUDWIG. Sir, you are going right to the heart of it. Examiner training and enforcement have got to be the heart of any approach. If we are going to avoid credit allocation—which we certainly don't want to get near—there has to be a level of subjectivity and the examiner has to play an important role.

In that regard, we have increased our examiner force. When I started at the OCC, we had 150 compliance examiners. By the end of this year, we are anticipating having 410. Moreover, the proposal is structured so that data collection starts in July 1994, and it is July 1995 when the system becomes mandatory. That gives us a full year for training, which we believe we need. We will involve community groups and bankers in the training. We have done this a little in the past.

I agree with you that the training and the coordination and the implementation are absolutely essential. I think it is important to get our people out of the office and onto the streets. They need to see the projects and walk the streets. But, we fully recognize that is our responsibility. It would be our responsibility, frankly, whether or not we have a new system.

Mr. RUSH. Mr. Chairman, I have a yellow slip, but I have one question.

Chairman KENNEDY. That is fine. Go ahead, Bobby.

Mr. RUSH. Can you elaborate on why the sex, income, and racial characteristics of applicants for small business and farm loans, as well as the size of the small business loans, was not included in the regulator's disclosure requirements?

Mr. LUDWIG. You are referring to race as well as the size of the——

Mr. RUSH. Race, sex, and income.

Mr. LUDWIG. The small business data will be sliced and diced according to the sales volume of the small businesses under the proposal. In other words, we will know whether the loan is to the smallest small business or the largest. In that sense, income data will be part of this. Moreover, we currently collect outside of CRA data on the basis of size of the loans, using that as a rough equivalent as to whether they are being made to small or large businesses.

In terms of collecting more detailed data or race data, I must say that we talked about it. It is a very hard judgment. I, myself, have a good deal of sympathy for the notion that we ought to collect more data, including race data. But as a group, the agencies felt that it was important to keep the data collection as simple as possible because this was about economic development. And the census tract data gave us a very good gauge for whether a particular area was low income, or very low income or moderate income. Unfortunately, in much of the United States those census tracts are, in essence, single race census tracts so we would have some gauge as to whether or not the lending was discriminatory. But we also felt that we do have strong fair lending rules that we are enforcing aggressively and that CRA was economic in nature. If we had to sacrifice something in terms of trying to get simplification, as a group we decided that this is where we would come out.

Mr. RUSH. Thank you, Mr. Chairman.

Chairman KENNEDY. Thank you very much, Mr. Rush.

Mr. Knollenberg.

Mr. KNOLLENBERG. Mr. Chairman, thank you very much. I am glad your plane got down.

In my opening remark I made a comment about the concern that I have about banks engaging in unsound lending practices to improve their rating.

I noticed Mr. Fiechter—I will come to you—you, in your written testimony, indicate that your personal goal was to insist or dispel any concerns that compliance with the CRA proposals in any way jeopardizes the safety and soundness of the whole process. And then you go on to make some comments about how the proposal does not encourage or expect a liberalization of underwriting standards to the detriment of safe and sound lending principles.

And it is the next statement that I wanted to direct your attention to. You say that: "It does, however, encourage institutions to be innovative in attempting to create products to meet the various needs of a diverse customer base."

And I guess it is in that area of the creativity, what products did you have in mind, and what innovation did you have in mind?

Mr. FIECHTER. One example—and we at OTS and, I think, all of the agencies, have instances of where banks have developed affordable housing programs, where they have created loan products that are not traditional in the sense, for instance, of downpayments for a traditional home loan where, without the downpayment, the payment can't be borrowed. We have, in some areas, found, for some ethnic communities, borrowing money from relatives. And it is for downpayments.

Getting the downpayment as low as 5 percent, in fact, has not produced the kinds of default rates that you might have with more traditional loans where the lower the downpayment, the higher the default rate.

The institutions we have talked to have said that these programs are expensive to put into place because you need to have lending officers that are more familiar with nontraditional sources of income, for instance.

Some types of payments beyond the traditional income sources, if properly underwritten, these loans have default rates that are equal to or, in fact, lower than the more traditional loans. That is what I had in mind.

Mr. KNOLLENBERG. So the idea could be to encourage the consolidation of monies from relatives and that kind of thing.

Mr. FIECHTER. That might be one area. Looking at a potential borrower who has changed jobs every 12 months, usually a red flag goes up if you haven't been able to, quote, unquote, hold a job.

In some of the low- and moderate-income areas, that is a sign of really progressing. If you take on lots of different jobs, that is the way you progress through the income ladder. And you have to look more carefully.

The point is that a loan made in Fairfax County by a lending officer using traditional standards may be fine in Fairfax County. If you are going into southeast Washington and applying those same standards, it may turn out that you turn down a lot of what, with further study, are a lot of very good loans. They take more work, though. That is what I had in mind.

Mr. KNOLLENBERG. This is not a character loan, but in a sense it is.

Mr. FIECHTER. In some senses, it is a character loan; but in no way are these institutions suggesting that they are going to throw money at the problem and change their underwriting standards in a fashion that causes higher default rates. That helps nobody.

Mr. KNOLLENBERG. Final question—and this could be for anybody, but maybe it is a minor thing—but in the comments I have heard, there is the distinction made between large banks and small banks, the suggestion that there is a separate set of standards that small banks have to pass muster on that is different than the large banks?

Is it just in your commentary that it comes up as a distinction.

As a matter of fact, is there one grand plan of passing muster that applies to all banks? Small or large?

Mr. LUDWIG. We have proposed very different examination procedures for small institutions versus large institutions. That doesn't mean the small institutions have an exemption or that they can redline. It does mean we recognize that data collection by small institutions may not only be difficult but in some ways meaningless. A small institution may exist in one small geographic area. Having that institution collect and give us data on the basis of geocodes may be meaningless, and just more paperwork.

Mr. KNOLLENBERG. They all have the same responsibilities to their communities.

Mr. LUDWIG. That is right.

Chairman KENNEDY. Thank you, Mr. Knollenberg. Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman. Mr. Ludwig, during your testimony you said that one of your objectives was to address the needs and real problems of real people. And I believe that has been the sentiment that has been expressed by the entire panel.

The district that I represent is one that has the lowest per capita income of any congressional district in the country.

I also represent the downtown Los Angeles area which has one of the highest homeless populations in the country. Yet, it is my understanding that low-cost, multiple family rental housing loans have been omitted from consideration under the lending test that has been administered to banks?

And if this is so, I would like to know why?

And then, what incentive would be there for larger banks to make these kinds of loans? Because many people whom I have just described will never be able to qualify for a single-family home and will depend on this kind of multifamily housing to be able to get off the streets or to be able to move out of a situation where you have two or three families living together.

Mr. LUDWIG. I am glad you raised that question. The answer is, happily, absolutely not—no loan is excluded. We tried to make this as broad as possible. We just used the word "loan" in recognition of what you are saying. Now maybe we can be more explicit. Obviously, this is an area in which we have created some unintended confusion. But, multifamily housing loans are certainly included.

Ms. ROYBAL-ALLARD. So there will be an effort to clarify that?

Mr. LUDWIG. Certainly.

Ms. ROYBAL-ALLARD. One of the complaints that I have heard is that the process by which the agency, especially the Federal Reserve, handles the CRA challenges is closed and they say bank-friendly.

Could you please respond to complaints that the agencies almost never hold public hearings or extend public comment periods even on protested applications that involve multiple States and that the agencies almost never deny a merger applications?

And if that is true, how is that going to be addressed?

Mr. LUDWIG. That is a good question. The new proposal involves the community much more than the current system. It involves it in a way that I am proud of, in a proactive way.

We envision the community getting involved earlier in the process than currently is the case. This will happen in three different ways. Number one, we will publish a list of those banks we intend to examine before examining them. That way, the community groups will know we are going in, and that now is the time to comment. We will take those comments seriously. In the implementation of this proposal at the OCC, we are going to go out and solicit information as we do our CRA analysis.

Number two, in the plan approach where, as an option, institutions can decide to develop a business plan, that plan must be published for 30 days to elicit community comment. We will seek out community comment. We will not judge the plan until we give the community an opportunity to comment.

Number three, in the small bank test, a bona fide community complaint can knock a bank out of the simplified examination. Here, too, we are trying to do this in a proactive way so that we get the complaint or the comment before it is just simply negative, to stop that application.

In terms of whether or not there have been denials of applications, I would say that although the system today has not worked well and certainly not perfectly, in many of these cases, there haven't been denials, but the approval of the application has been conditioned upon changes in the way that the bank has dealt with the community. There have been approvals conditioned on the basis of the bank's fulfilling its CRA responsibility more adequately.

Ms. ROYBAL-ALLARD. One final question with regards to how you are going to be seeking pubic comment. Is it going to be just through some of the traditional ways of putting an ad in the paper? How will that public comment be solicited?

Mr. LUDWIG. That is a good question. It will be part of the implementation, not typically in the rule. Maybe we ought to give some thought to including it in the rule, but we would want to do it in a way that is most effective in terms of actually getting comment. Your point is well taken.

Ms. ROYBAL-ALLARD. I would like to suggest that if it is put in my community, in the *L.A. Times*, even on the front page or page 5 or 34, it is never going to be seen.

Yet, if you use, for example, announcements through churches or through the local-elected officials, they will then be able to get that information out, and we have been very successful in where there has been no attendance at hearings. We had up to 1,000 people in hearings where otherwise people have never attended.

I think that is important.

Chairman KENNEDY. Thank you.

Congressman Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony and a special warm welcome to my fellow Nebraskan. I have a limited amount of time, so I will focus on one area.

But before I do that, I want to commend you, Mr. Ludwig, and all of you working in cooperation, to attempt to bring reform to the method for assessing the adequacy of actions by financial institutions, to meet the CRA requirements.

They go back to 1977, as you all know. They have, by and large, been very unsuccessful, it seems to me, in many institutions. They have created an incredible amount of meaningless paperwork, especially for small facilities. And they have been enshrined as something that has been untouchable. And we have seen that the Congress has added immeasurably to the regulatory burden relief of financial institutions to the detriment of savers and institutions time and time again.

I think you have made a good start.

Mr. LUDWIG. Thank you.

Mr. BEREUTER. I will focus on the special alternative assessment methods for small institutions. And I commend you for that differential approach. Those institutions do constitute 77 percent of the total banks and thrifts in this country.

The one area of controversy I have noted immediately from some of my colleagues is their reaction to the 60 percent loan-to-deposit ratio. There is a "Dear Colleague" letter that floated around dated February 3. I was solicited as an original signer. The three original people are, not surprisingly, all members of the Agriculture Committee. I didn't sign on because I think that they are wrong in suggesting that no fixed ratio is appropriate.

And I noted, Mr. Ludwig, in particular, your testimony on page 9, you are saying that the loan-deposit ratio of 60 percent or more would be presumed to satisfy the test for reasonable loan-to-deposit ratio. The 60 percent ratio would not be a requirement or a bright line test that an institution would either pass or fail, rather it is intended as a helpful presumption that would provide a simplified method for demonstrating compliance for roughly half the community banks whose ratio exceed 60 percent.

Despite that, the concern exists that examiners will come to think of it in a different fashion and that any kind of arbitrary presumptive level at 60 percent or any other percent that is fairly high may fail to take into account other relevant factors. And I quote, such as competition in the markets, local and regional economies, loan demands, community characteristics, and ebb and flows of the marketplace. So what additionally can you do to assure me and my colleagues and the financial institutions that are writing me in great numbers now, from my State and surrounding States, that the 60-percent presumption will, in fact, be working in their favor and not against them?

Mr. LUDWIG. This is an area which we clearly did not explain well in the rule, and we are going to have to do a better job of it. That is to say, the test is a reasonableness test. We avoided bright lines because we didn't want to have credit allocation and because of the funny anomalies you get when you have a bright line. In a recession, 60 percent may be so high that you are giving banks an incentive to do things they shouldn't do. In very heavy lending times, it may not reflect what most banks are doing either. We tried to put the 60-percent figure in as a simplification so that banks could, if they were above 60 percent, avoid having to worry about that. But, clearly, we didn't explain it well. And we must, in the final rule, have it sufficiently clear that this is not a bright line test.

Mr. BEREUTER. Mr. Chairman, may I ask if others would like to respond to this, my only question?

Chairman KENNEDY. Sure.

Mr. HOVE. Congressman Bereuter, I know that you are very familiar with agricultural areas and familiar with the other areas of the country that are involved in agriculture. The loan-to-deposit ratio is an average. As you know, borrowings in an agricultural area are high in the spring planting season and low after crops are harvested.

It is an attempt to use a reasonable test as to what is the loan-to-deposit ratio that should be used in that area: What are loans that are available? How well is the bank responding to that. Are they, in fact, making the loans that are necessary to provide credit to agriculture, business, and consumers?

Mr. BEREUTER. Well, I think these comments might be helpful to have in the record and somewhat reassuring, I hope.

Thank you, Mr. Chairman.

Chairman KENNEDY. Thank you very much, Mr. Bereuter,.

Nydia Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I want to commend the panel. I believe that the proposal moves us in the right direction by establishing a performance-driven system. This will better serve both the industry and our communities. However, there are some areas of concern which are important to address. After all, if we are going to invest time and energy in changing CRA, let us do it once and let us do it right.

I have a few questions, and those questions could be answered by any of the members of the panel. I understand the banks that operate in many cities will receive a single, overall rating based on sampling of the service area.

How will the sample be selected? And how can you detect whether a bank is doing well in one area but not doing well in another when you just sample?

Mr. LUDWIG. The sampling is intended to be a statistically random sample so that if you went to an institution year after year, you would not be choosing the same areas. You would actually be sampling so there would be some certainty that the bank was complying with its CRA requirements everywhere throughout its system.

Now, we are not going to be blind to some institutions that are highly concentrated in and around low- and moderate-income areas. These are areas to which we will pay special attention. But the notion of sampling is not that you simply look at one part of a system. Rather, it is meant to efficiently use the examiner force so that we get a genuinely useful view as to the whole system.

The performance evaluation would list the grade in each area sampled. In other words, we would know, and it would be available to the public, what the grade was in each service area. We would homogenize it for the final overall result for the institution. But everyone would know whether they got an A in one area or a Z in another area. Obviously, it would be helpful to the institution, the community groups, and to us to be able to say what is going on in any one area.

Ms. VELAZQUEZ. The proposed rule gives banks the opportunity to respond to an examiner's findings and appeal for a higher rating. This appeals process seems like a fair exercise; however, if banks have the opportunity to appeal a low rating, why is the public not offered the opportunity to respond to the bank's appeal? And why is the community not offered the opportunity to appeal a rating that is considered too high? Isn't that a double standard?

Mr. LUDWIG. We do not, in the rule, have an appeals process. The banks can appeal according to the normal appeals process for all regulatory matters. We have tried to include the public in a variety of ways early in the process; that is, before the banks even get a rating, we are going to be soliciting comment. The public, in the end, has more than an appeal; it has a stopper. When a bank files for an application, public comment is solicited again at a very serious point in the evolution of the institution. But I hear your concern. In terms of getting balance, that is something we are going to have to think about very hard.

Ms. VELAZQUEZ. The fact is that under CRA, current CRA, very few mergers are denied. That is a fact. How do your new regulations address the complaint that mergers' applications are a foregone conclusion?

Mr. LUDWIG. The proposed system really does address it in that we will know for the first time what a bank is doing. You can't, with a straight face, say a bank is good or give it a passing grade or let it go through a merger if it, demonstrably, on paper, with numbers, has a rotten record—not just whether they have gone out and had outreach but whether they are making loans and investments. That also is helpful to the institution beforehand because if they demonstrably have a rotten record, they know that they are going to get in serious trouble with the regulator at the time of the application process and most likely with their community.

Ms. VELAZQUEZ. Just one final comment. I am sure that you will agree with me that small businesses owned by minorities experience discrimination on the basis of their race, ethnicity, and gender of the business owners. I just would like to raise and to echo Mr. Rush's concerns about omission of this type of data. And I would like to ask for careful consideration of this matter.

Mr. LUDWIG. Thank you very much. We will give that careful consideration.

Chairman KENNEDY. Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Would this reform initiative have to be modified in any way if we pass an interstate banking law?

Mr. LUDWIG. No, sir, it would not. We are looking at the institution throughout its service areas. If you take my home State of Pennsylvania as an example, you have got Philadelphia on one side and Pittsburgh on the other, quite a distance apart and with sizable populations. There is not much difference in terms of Philadelphia and Trenton, New Jersey, in terms of making an honest evaluation. So we have taken that into consideration in this proposal, and we would not have to make modifications if the interstate bill is passed.

Mr. BACHUS. And the branches?

Mr. LUDWIG. Yes, sir.

Mr. BACHUS. Governor Lindsey, let me ask a question that I think not only concerned this subcommittee but the entire Banking Committee. We just had a quarter percent increase in the discount rate. Yesterday's budget figures, do you think they need to be changed in any way to accommodate higher interest rates?

Mr. LINDSEY. As I understand the assumptions in the budget—and I have to say, I have not, in the last 24 hours, had a chance to go through the document—but there was an assumption that interest rates would rise during the year. I believe that was incorporated.

So as of this time, I would not say that the budget numbers have to be reevaluated, and I can't predict what will happen throughout the year with regard to interest rates.

Mr. BACHUS. But you think there was some incorporation into the budget that there would be some higher interest rates?

Mr. LINDSEY. It is my understanding from some public statements of Secretary Bentsen that a quarter point increase was anticipated and was incorporated in the budget.

Mr. BACHUS. Do you expect that we will see slower than anticipated growth this year?

Mr. LINDSEY. I think we are probably on a course of sustained, moderate growth. And I would have no reason to question the assumption in the budget about economic growth.

Mr. BACHUS. Thank you. I have one final question for Mr. Fiechter.

You mentioned compliance concerns that thrifts have with compliance under CRA. I am sure you are aware that several of us on the Banking Committee are glad we have our semiannual oversight committee hearings.

Is Secretary Bentsen—he is aware of our request that these two oversight hearings be held, is he not?

Mr. FIECHTER. Yes, I believe he is.

Mr. BACHUS. Is he willing to conduct these hearings?

Mr. FIECHTER. I believe they are scheduled by the chairman of the House and Senate Banking Committees. It is up to the committee chairmen to schedule the hearings.

Mr. BACHUS. Does the Secretary have any position? Is he willing to go forward with these hearings?

Mr. FIECHTER. I would assume so.

Mr. BACHUS. Do you have any reason why we have not had these required hearings?

Chairman KENNEDY. Mr. Bachus, I don't think it is appropriate, in terms of the line of questioning, to ask Mr. Fiechter those questions.

In fact, the chairman of this Committee has addressed those questions. Those are going to be dealt with by the full committee that you serve on.

I don't think it is appropriate to be asking Mr. Fiechter those questions.

Mr. BACHUS. I was asking for his personal knowledge, if he knows, why we hadn't had the hearings.

Chairman KENNEDY. I understand the purpose of your question, Mr. Bachus. There is no misunderstanding on my part.

Mr. BACHUS. I was searching for information.

Chairman KENNEDY. I would just ask you to withhold the question until the full committee, Mr. Bachus.

Mr. BACHUS. OK. Thank you.

Chairman KENNEDY. Mr. Wynn.

Mr. WYNN. Thank you, Mr. Chairman.

I would like to thank the regulators for the work that you have done in this area. You have made progress, and that is important. I introduced H.R. 918, the Small Business Loan Disclosure Act which included many of the provisions that you are now recommending to us in terms of itemizing the actual loans that are being made; but it appears that you have omitted the most important factor, which is race.

We have all kind of worked in a courteous way to talk about community reinvestment, but we have to be candid and recognize that underlying this discussion is the realities of the HMDA data and also the Boston Fed study which basically said there is racial discrimination in lending.

Therefore, to go back to my colleague, Congressman Rush's question: Why have you not recommended that this data, which documents amounts of loans made in specific geographic areas, not reflect the racial or ethnic characteristics of the loan applicant?

Mr. LUDWIG. As I mentioned, Congressman Wynn, I am personally sympathetic to your concerns. As a group, the banking agencies felt that we are dealing aggressively with racial discrimination, have the tools to deal with that issue, were very concerned about adding another data collection requirement when what we want to do is give banks an incentive to make loans in low- and moderate-income areas. I am very sympathetic to your concerns, and we are certainly going to take this issue up again as a group.

Mr. WYNN. When you consider that many of the neighborhoods that you say need service are characterized by race or ethnic communities, that data ought to be there as well.

Let me ask you: Is there any criteria relating to personnel diversity? In every discussion that I have been a party to on the subject of lending discrimination, the question continues to come up: It is the lack of minority loan officers and the lack of minority board members and the lack of minorities on loan committees that have a lot to do with whether loans are being made. And I don't see that particular issue being addressed.

Shouldn't personnel diversity be one of the criteria by which these institutions are evaluated?

Mr. LUDWIG. Let me tell you how we try to deal with that, and maybe this will allay some of your concerns about the importance of data collection by race.

Our view has been that you simply can't make loans in low- and moderate-income communities that are largely of one ethnic variety or another without recognizing that you have to have loan officers that reflect the people you are serving. You can't do it. And, interestingly enough, in a recent American Bankers Association newsletter, they gave advice to bank CEOs for 1994 to hire African-Americans and other minorities as officers and board members to deal with the issues of the latter part of the 20th century. How can you have a significant number of loans in a census tract that is low- and moderate-income and a largely minority community if you

don't have sensitivity to connecting with the people you are serving? We felt that would, in fact, take care of a lot of this problem.

Mr. WYNN. If we accept your comments—and I do—then shouldn't we say that if a bank doesn't reflect that kind of personnel diversity that you just described as essential to making loans in an underserved community, that that is evidence of a lack of good faith and ought to be considered when you are talking about their CRA evaluation?

It seems to me to go hand and hand, and I would strongly ask that you would consider that as one of the criteria that ought to be looked at.

The other question I have relates to the sanction, and it has also been raised before. I think we should be candid. There has been a poor record in terms of sanctions.

We are now entering an era of interstate banks, and it seems like that situation is likely to become worse.

What can be done to strengthen the sanctions for failure to meet CRA requirements, because I think that is the essence of what we are doing. Your work has been fine. I, obviously, want you to go further, but what can be done when there is not compliance beyond what we are seeing?

Mr. LUDWIG. One thing we are doing or proposing to do is that if a bank has the lowest rating, it will be subject to the normal agency enforcement procedures for the first time. In other words, if a bank thumbs its nose at the law, it is subject to civil money penalties and cease and desist orders under this proposal for the very first time. That is controversial. There are a lot of people who don't like it. We feel it is appropriate. We believe that will be a powerful incentive for banks not to be in substantial noncompliance.

Mr. WYNN. What is the standard for substantial noncompliance?

Mr. LUDWIG. Under the new rule, it is very complex. A bank has to be making a small number of loans in its area.

Mr. WYNN. You are allowing extra credit for the so-called innovative lending. Could this extra credit be used to offset a failure to actually provide service which is a key criteria or investment. They say we have this new innovative loan product, but you are not taking any investment in the community.

How does that extra credit process work? And could it, in fact, offset significant deficiencies in one of the other areas?

Mr. LUDWIG. I think it would be much harder to game under this system than past systems.

Mr. WYNN. I think that is true. But acknowledging that, could they do it under the new system that you are proposing?

Mr. LUDWIG. We would have to be blind, because I know that you would haul us up here in a second. If an institution was not making the loans needed by its community while other institutions were doing so, and they suggested that because they had one innovative program they ought to be given a passing grade—you would know it, and we would know it. We would have significant pressure on us for that kind of anomaly not to happen. It would be so much more obvious than it is under the current system.

The one thing I would say, sir, is that you really do want to give people an incentive to engage in a lot of these innovative programs.

I am convinced that people have viewed as unsafe a lot of loans that are perfectly safe and that is not the issue here. As banks reach out to serve the population that has been disadvantaged more and more, it will take innovative new ways of thinking; and they ought to be given an incentive to do that.

Mr. WYNN. I agree. But it argues for my colleague, Ms. Velazquez' point that there ought to be an opportunity for the community to challenge or appeal these ratings where this may have occurred.

Mr. LUDWIG. Good point. Yes, sir.

Chairman KENNEDY. Good questions.

I now recognize Mr. Watt for 5 minutes.

Good questions, Mr. Wynn.

Mr. WATT. Thank you, Mr. Chairman.

It seems to me that the freshmen members of this subcommittee have formed a chorus that I will add my voice to at the bass end of the level. We have got some sopranos and altos and tenors, and I need to express my concern about the gathering of information on race and income also. And go back maybe to a comment that you made, Mr. Ludwig, earlier.

I take it that your response to our concerns, at least in part, is that information is being collected based on census tracts and that that would somehow correlate into race and income data, and that that is, in effect, an economic—you used this term, "an economic evaluation," not a race evaluation or—I think that was the paraphrasing of what you said.

What about the case where you have people moving into census tracts, which happens quite often in this day and time, and there is a process of what we call "gentrification" going on and essentially you have suburban residents moving back into those census tracts that you are talking about?

Wouldn't that be a case where you simply need to have race criteria to evaluate what the bank was doing in terms of actually supporting the existing neighborhood as opposed to what might become the neighborhood over time?

And how would you respond to that?

Mr. LUDWIG. Your comments on this point, as well as those of your colleagues, are thoughtful comments. We are strongly of the view that this should not be a formulaic and quota driven system. So there is subjectivity involved in terms of an examiner looking at an institution and what the institution is actually doing and an opportunity for public comment. I would think it surprising if there was not a hew and cry over an institution that was basically making its loans in a limited way, vis-a-vis gentrification. Also, we would have information on housing loans from the HMDA data so that we could do some analysis to identify where home loans are being made for gentrification. That is, the housing data would be more detailed.

Mr. WATT. Clarify for me the component which that data would be used in the CRA evaluation process. And is it formally taken into account? Or is that a separate body of data that you might informally take into account, but there is no formal process for it?

Mr. LUDWIG. In order to simplify institutions' data collection, we would be using what is already out there as opposed to trying to

invent a new mousetrap. We would be using existing HMDA data, and collecting, for the first time, new consumer and commercial loan data. We would be homogenizing some of the data to make some of these calculations. But, we have tried to create a system that cannot easily be gamed and doesn't create unintended anomalies.

Mr. WATT. Let me turn my attention to another concern, and that is this small bank exemption—or if not exemption, at least different standard.

Am I correct that—I had the figure 74 percent. But Mr. Bereuter said it was actually 77 percent of banks or small institutions that would fall into this category?

Mr. LUDWIG. Yes, the lion's share of institutions in this country, 77 to 80 percent, are below $250 million in assets.

Mr. WATT. I understand that. Isn't it also true that that 77, 80 percent of banks typically has a disproportion of the higher percentage of the low CRA ratings?

Mr. LUDWIG. I don't know whether that is the case, to be honest with you. My staff is telling me it is true.

Mr. WATT. If that is then the case, how was that $250 million level set? And why would you relax standards for institutions which presumably have a higher or more of a problem?

Mr. LUDWIG. Let me explain. That is under the current rating system. Under the current rating system, banks are disadvantaged to a degree if they are small, because they cannot afford to hire, either internally or externally, CRA consultants. One small bank, for example, came to us with a good record, but they had to go out and pay $55,000 to hire a CRA consultant to create the kind of paperwork they needed to get a passing grade.

So it isn't necessarily the case that the smaller institutions aren't doing the job. We just don't know that. We have been evaluating on criteria that don't make any difference, so that although the ratings may be lower, it doesn't necessarily mean that they are doing a bad job.

And $250 million was a rough guesstimate. There is no magic in $250 million. We looked at the size of the institutions and the kind of staff they tended to have, given the various sizes. In other words, how many people do they have on their payroll, and how able are they, given their profitability and size, to perform the geocoded exercise that we have for the larger institutions? It is a little bit of feel and touch that below this line it would be much more difficult and less meaningful. But, when you have a bright line, there are going to be anomalies in terms of institutions that fall on one side or the other.

Chairman KENNEDY. Thank you very much, Mr. Watt.

I, first of all, want to thank all of you for coming this morning. I apologize for being late. I want to commend all of you for the renewed emphasis that each of you has placed within your agencies on CRA compliance and with fair lending in general.

While I believe the changes that have been proposed are submitted with the goal in mind of actually increasing lending and decreasing opportunities for discrimination in this country, I do think that there are several issues that need to be raised and need to be dealt with.

I want to thank the other members of the subcommittee for bringing up some of the concerns, certainly that I have, with regard to these institutions' abilities to make loans and their willingness to make loans as well.

And I particularly want to thank Gene Ludwig for the efforts that you have made to include more data regarding small business lending. A few years ago, I attempted to include data about small business loans as part of HMDA. It was defeated by this subcommittee, and the full committee. We did succeed in amending HMDA to include data on race, income, and gender, but not small business loans.

But in any event, the fact is that, as I have mentioned, there are some areas that I am concerned with. As you know, I have requested the GAO to do a study of the actual implementation of the existing CRA, and—Larry, you are nodding your head—they came back and said there were significant problems with CRA compliance as it pertains to the actual examiners that are going in and making the determination. The fact was that there is a distinct problem with the training programs that have been set up.

So I would like to hear a little bit about that.

Second, correctly—and Larry, this is basically another area that I think you know probably more about than everyone—the HMDA data that you are actually receiving from institutions is, in many cases, 30 to 40 percent inaccurate. That is information according to the GAO study.

We also understand that if we just look at the years when President Bush was leading our country, the number of satisfactory or outstanding CRA ratings was about 89 percent. Today it is about 93 percent.

So you guys have actually been more generous in terms of your satisfactory and outstanding ratings. And yet, at the same time, if we look at the HMDA data, it has not demonstrated significant improvement. I am not questioning the fact that you have some outstanding and innovative programs out there. But that leads me to an even greater problem that you might have created inadvertently. If I run an institution that is not active in terms of minority funding and have a substantial noncompliance rating, and I know that I want to make an acquisition of another institution, I could have a problem. Under your proposal, I can basically buy my way out at the last minute and move up two grading levels.

While I know you make these changes with the best of intentions, in fact, if we look at the overall situation, it might have unintended consequences. All you have to do is drive into parts of Mel's district, or parts of my district, and you will still see a hell of a lot more banks in Brighton, Massachusetts, than you do in Roxbury. You see a heck of a lot higher degree of home ownership in white, blue-collar Boston than you see in blue-collar, black Boston. I think that is probably true. I know it is true in every city that I have driven in around this country.

I am not certain that we are really getting to it. I am concerned that what we have done is answer the political problem in America, which is, hey, small banks are popular, even in Democratic districts; let's give them an exemption. What we are not doing is finding a way to make these banks provide the loans that they should

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be providing. So I am very concerned that we have set ourselves up for a political win that is, in fact, a hidden defeat for the very people that we are here looking out for.

So, Mr. Ludwig, maybe the four of you can get back to me on those concerns.

Mr. LUDWIG. Let me respond to your concern here. First of all, if a bank is in substantial noncompliance, Mr. Chairman, for the first time it will be subject to all the enforcement tools we currently have available. It couldn't sit there year after year and have a substantial noncompliance rating. We would have the power to issue a cease and desist order or civil money penalties.

Chairman KENNEDY. How many banks currently have a substantial noncompliance status?

Mr. LUDWIG. It is in the neighborhood of dozens, not hundreds.

Chairman KENNEDY. Does that meet your instinctive sense of the number of noncomplying banks? How many banks are in this country?

Mr. LUDWIG. Currently, there are some 13,000 depository institutions.

Chairman KENNEDY. Do you think it is appropriate that only a couple of dozen have a substantial noncompliance record?

Mr. LUDWIG. I would say this. Your comment about the 93 percent and the 87 percent is a similar comment. The current system can be gamed. There is no way on Earth you can tell actual performance because ratings are based on 12 assessment factors, which are largely subjective. Bankers have told me that they meet with their Kiwanis Club, and they put another memo in a huge pile and that is what they are judged on—subjective activities that don't mean loans in the community.

Chairman KENNEDY. Mr. Ludwig, I ask these questions knowing that in your heart you are trying to get the right thing done here. You say that the system that you are putting in place cannot be gamed as easily.

However, I am concerned that, without having the four of you take some stand on what you really believe is the situation in the real world today, that all these systems will not work. Essentially, it is similar to one of those grading charts when you were in high school.

They are going to say, listen, no matter how well anybody does on the test, so many people are going to pass, so many people are going to be in the middle, and so many people are going to fail. So it doesn't matter how you do the test in terms of what you write. What does matter is how many are going toward good, how many are going toward bad, and how many are going toward the middle.

No matter how you arrange the deck chairs, if that is what you have ended up with, then it might look good, and it might smell good, but, boy, I don't think it is going to change much out there.

Mr. LUDWIG. If you look at Boston, there are white census tracts and black census tracts, and we are going to be looking at all census tracts and whether there are loans made in each. Your comment about people learning to game any system is well taken, and a bell curve will most likely develop. But we will have shifted the bell curve.

Chairman KENNEDY. Do you think that, under this system, there will be more banks that fall into the substantial noncompliance category. Will there be far less institutions gaining satisfactory and outstanding grades?

Mr. LUDWIG. I think that all banks and—hopefully, all banks will try to get satisfactory.

Chairman KENNEDY. I want them to try.

Mr. LUDWIG. And, we will be measuring them on a meaningful scale. I think we will have to come back and revisit this periodically. We have committed among ourselves to hold hearings again in 2 years after this is put in place to see whether or not it is working correctly. I think that is very, very important.

Chairman KENNEDY. I appreciate your answers, Mr. Ludwig. I have taken perhaps more time than I should have. I would like to give a brief chance for the other three witnesses to respond.

Mr. LINDSEY. I would like to address your question about the HMDA data quality. It is an issue on which I agree with you completely. I think we definitely have to work much harder in that area.

Let me explain first why you called on me and why I am the one to answer this question. Each of our agencies collects the data. And we at the Fed collect the data from about 600 of the 9,000 depositories. But the FFIEC, which we all sit on, contracts with the Fed to do the computer spread. So we divided the labor in that regard.

With regard to the inaccuracy levels, the first thing I would point out is that we are taking this matter very seriously. In two cases that I know, Mr. Chairman, you are very familiar with, Fleet and Shawmut, an explicit reason given for the Federal Reserve Board's action against those institutions was highly inaccurate HMDA data. And you know the consequences that they faced, and they got a lot of attention. So we think that this is important. I think we rang a gong for all bankers in America that they have got to take this seriously, getting it right.

At the same time, let me point out what we are able to do and what we are not able to do with regard to resolving the data situation. We get raw data in. We have a number of computer screens that can detect obvious errors. For example, if it comes in that a number is zero for income, or zero for mortgage application, well, the computer is smart enough to know that that is a mistake, and we send it back and we ask the bank to correct it.

But there are things that the computers can't check, and it requires our compliance examiners to go into the bank. For example, if someone says that they are black, they are white, or vice versa, there is no way for the computer to know that. There is no way for anyone aside from the person who collected that data to know it. So part of the correction process is going to be our compliance people going around and making sure that people check the right box.

Where that is a real problem, and where I think a lot of the data errors are coming from, is on the income question. What we are dealing with is initial applications by individuals. And folks tend to round their income. They also may tend to round it up on their initial application. Where the numbers are verified, oftentimes, a lower income level is produced.

And so, the application file is going to be scored as having an increased level of income. The bank will interpret one level—you understand what I am talking about.

Those are the kinds of problems that are going to be very difficult to get at. I don't believe that the error rate is 30 or 40 percent. I think it is high. And I think it is too high.

Chairman KENNEDY. Is there anything, Mr. Lindsey, that could be done in terms of those new regulations to help you improve this?

Mr. LINDSEY. One thing we are looking at; I have ordered our staff to look at how we can deal with things like the income problem. Do we really care, for example, what the applicant's initial claim of income was? Or do we care what the actual verified income was? I tend to think it is the latter.

That is the kind of thing, I think, is going to get at a lot of the problems.

Chairman KENNEDY. Do you have something else?

Mr. LINDSEY. One other thing. One thing that I believe we are all doing is that we are now beginning a process of fines for banks who file late and who file with significant data errors. And that may well help the matter, too.

Chairman KENNEDY. Terrific. I think that what you might do is write me a very brief letter. You don't have to send me a formal letter, but a brief letter indicating where you see the substantial problems and what kinds of changes that you think would be helpful to extract a better accuracy rate from the institutions themselves. We can then talk about how we may be able to implement that.

Mr. LINDSEY. I would like that. And I would particularly like it if you give me a little time. Because one thing we are doing, we have to go back and see what the problem actually is.

And I will be happy to give you what my initial impressions are, but——

Chairman KENNEDY. Have you looked at the GAO study?

Mr. LINDSEY. Yes. I have read it very quickly. I thought they had a lot of very good observations and certainly ones that we are going to take into account.

Chairman KENNEDY. Thank you very much.

Mr. HOVE. Mr. Chairman, I think that the FDIC certainly is very interested in finding those places where there are errors and correcting those errors. And, in fact, as Governor Lindsey mentioned, we are preparing cases to fine late filers and find the data that is in error.

We also have started a project at FDIC where we are making investigations of HMDA disparities. And where we see disparities in the HMDA data where there are large rejections, larger than what would be normal, we have designated 100 examiners throughout the country to specifically look at these institutions and find why these disparities exist and try to correct them and ferret out any problems that there may be and identify those that really are discriminating. And we are serious about this.

Chairman KENNEDY. I heard you made that announcement the other day, Mr. Hove. I want to congratulate you. I think that is an important step forward. Still, more needs to be done.

Mr. Fiechter.

Mr. FIECHTER. I think we are all working on getting more timely accurate HMDA data.

On your question of will more institutions fail under the new proposal, I would be reluctant to prejudge the outcome in a couple of years. I don't have any doubt, however, that it is a more meaningful standard that we have proposed than what we had before.

Chairman KENNEDY. I want to deal with that directly. There is a sense, I think, by the country in general that we are out of touch.

Now, I am trying to let you know that you must do something about this. People don't need to look at the phone books of HMDA data and all the reports and all the silly questions that bank examiners ask chairmen of boards of banks about board meetings and all that hogwash. It doesn't make any difference to some poor person that has enough money to pay $700, $800, $900 a month in rent, and yet can't buy a house. Those people need to know that they can go to a bank and buy a house. That is what is not getting across.

All the efforts that you make with regard to this issue, the reason why you are doing it, other than your personal instincts, are because it is, in fact, being recognized as a legitimate issue out there in the country. People understand that if we can have economic development in other countries, we can have economic development in the United States in very poor communities.

When there are banks that are doing good things, we ought to congratulate them. We ought to put them up on a pedestal and have other people try to emulate them.

But, fellows, there just is not enough lending going on in this country to poor people and to people of color. And banks are not getting out there and doing it. Meanwhile, you are giving them higher ratings. You ought to be willing, I think, to come forward and say, yes, in fact, unless banks change, if the existing lending rates continue and nothing changes out there, more banks are going to fail. Less banks are going to get a satisfactory rating, and less banks are going to get an outstanding rating because the system you have in place right now is broken; it doesn't work. Ninety-three percent of the banks ought not to be getting good or outstanding ratings while the kind of lending discrimination that the raw data, even if it is that inaccurate, Governor, demonstrates, in fact, exists.

Anyone who drives around urban America doesn't need this data. All you have to do is look. There are hardly any banks in the black communities. There are very few in the Hispanic communities. There are very substantial differences in home mortgage rates versus rental rates as well as the lack of ability of people to own their own small businesses in those communities.

I will say it until I am blue in the face; but the fact is that we need you to help. I think you are making an effort. However, I think you have to be clear that these are going to be tough regulations to finally get the job done.

Mr. Hinchey.

Mr. HINCHEY. I am just agreeing with you, Mr. Chairman.

Chairman KENNEDY. OK. Thank you.

Do you have any questions?

Mr. HINCHEY. No.

Mr. McCANDLESS. Mr. Chairman, if I may take a little liberty here with respect to the subject involved and the gentlemen at the table are the shakers and movers of our industrial complex, financial complex, you collectively—not you as individuals, but you collectively—have created an environment of such a negative nature that people are forced to come to what it is we are talking about here in the way of regulatory power. Let me explain it.

We no longer have loan officers in these banks. The loan officer comes in and he is the regulator, and he criticizes this particular portfolio, and he criticizes that particular portfolio as being substandard, packs up his suitcase in 1 day or 2 days and leaves. You have got those banks so afraid to loan money, irrespective of what the ethnic background or the individual's standing is in the community, that they don't want to step out.

For whatever value it is, I was in the automobile and truck business for 22 years as a dealer. All of the things that I sold had recourse condition of sale contracts. So I have a certain respect for the credit statement and what it represents in the way of an individual.

Your loan officers can no longer take that credit statement as a profile of that individual and make a judgment call based upon whether that person has the willingness and ability to pay. They have to meet some kind of a Federal or other type of regulatory confirmation in terms of a ledger sheet with a certain amount of this or that.

And it is going to, time after time after time—and I can give you all kinds of examples if you would like to have them from my district because, over a period of time, I got pretty well acquainted with the financial industry; and they are frustrated because they can't lend this person money that they have lent to for years to conduct the affairs of a small business.

Unless you overcome that, it isn't going to make a darn bit of difference whether it is ethnic or nonethnic. The ethnic part is going to be a part of who is left out. This attitude has cost this Nation and is due to what took place in the 1980's. What took place in the 1980's was not attributable to a loan officer sitting across the counter or the desk from a person who wanted to borrow money.

That person paid it back. It was the guy upstairs that borrowed the big figures and went out and invested it in some type of a venture that cost this Nation and that bank its charter and the money involved.

Now, we have been talking here—and I sound like a lecture, and I probably am. But I am frustrated by this because of what you can create in the way of a social structure to satisfy what it is we are sitting here about, if you have the latitude as a loan officer and your bank has the policies necessary to follow up.

But the policies are not going to be forthcoming; and, therefore, the loan officer is not going to be forthcoming. So everybody sits with their hands tied and are afraid to do anything because they will be criticized by the regulators for stepping out and making loans the way they used to.

Thank you, Mr. Chairman.

Chairman KENNEDY. Thank you, Al. I agree with a substantial portion of what you are talking about which, I hope, is a good omen for the next year.

I want to thank all of you very much for coming forward and for providing us with excellent testimony this morning. We look forward to working with you over the course of the next couple of months to refine some of these ideas that have been put forth. Thank you for your effort.

Our next panel is really a different panel. It is a panel that centers around Marshall Plummer, the vice president of the Navajo Nation. He also serves on the Select Committee of Tribal-County Relations, the New Mexico Association of Counties, and the McKinley County Commission. We want to thank you very much for being here. Have a seat and begin your testimony when you are ready.

STATEMENT OF MARSHALL PLUMMER, VICE PRESIDENT, THE NAVAJO NATION

Mr. PLUMMER. Thank you, Congressman. We submitted a written statement. What I will be doing is touching on certain points.

Yes, we are different in many ways, and we are unique, and we are asking that some consideration be given to how Indian nations may be treated under this particular act.

I testified on October 1, 1993, before this group in regards to the CRA, and we have some remaining concerns that I would like to propose at this time.

But before I do that, let me just apprise you of a situation that has recently been dealt with by Janet Reno and, of course, Eugene Ludwig.

This particular matter happened in South Dakota at the Black Pipe State Bank. There was a settlement wherein the bank was refusing to make secured loans to individuals when the collateral was located on the Indian Reservation, also placed credit requirements on American Indians that it did not require of non-Indians. And the Indians, of course, were charged greater interest rates and finance charges.

This particular case, I think, is just an example of the situation with Indian tribes across this great Nation of ours.

The Navajo Nation, being the largest in land and population size—the size of West Virginia, as I stated in my previous testimony—has only three banks on its lands. We have 3,000 miles of paved roads compared to West Virginia's 18,000. The lack of financial institutions has been a tremendous hardship on the people that I represent.

As an example, it is not common for employees, either of the Federal Government or the tribe or other agencies that are present on Indian Reservations, to drive to deposit their checks or cash their checks a 4-hour round trip. And I am not talking about a traffic jam or anything. This is just straight driving at 55 miles per hour. And the distances are so long, makes it very difficult.

Because of the fact that Indian Reservations are held in trust by the Federal Government, it makes it very difficult for bankers to provide loans to members of our tribe—of our many tribes across this land.

In addition to that, there are ambiguities in how banks interpret some of the language that is presently in place. We need to clarify some of the language that is currently in place.

Also, to address the fact that the landholdings that we have held in trust, and trying to find ways as to how Indian tribes may be treated. We are not like an urban area or a suburban area——

Chairman KENNEDY. Mr. Plummer, I know that we have talked with you about the fact that we are under somewhat of a tight timeframe, because there are other witnesses that want to come forward and testify who have tight schedules as well.

I am very, very interested in hearing your specific concerns as to how this subcommittee can assist the Indian tribes. We have heard your testimony in the past about some of the great difficulties in distances that exist on the reservation itself. I wonder if you might be able to focus your oral testimony this morning on what you would like us to focus in on in terms of the specific problems you are having with CRA and what kind of action you would like us to try to take to assist you.

Mr. PLUMMER. Thank you, Congressman. I will, then, immediately go to the things that we would like to provide as suggestions.

Chairman KENNEDY. Thank you.

Mr. PLUMMER. The fact that there are not many banks and the fact that there has been little activity on Indian Reservations, we are asking that a study, a thorough study be done by the four institutions that have oversight so that we can then get a feel for how severe the problem is.

That is number one.

Number two, that small banks and thrifts not be exempt from providing data on geographical distribution on loan applications, denials, and purchases to the public.

Third, that small banks not be exempted from data collection requirements.

Chairman KENNEDY. Would that only be on reservations?

Mr. PLUMMER. Yes, sir. This would be banks that would be adjacent to reservations because the three banks that we have presently are considered—is considered a large bank, but small banks that are contiguous to the reservation.

Fourth, that we have a clarifying statement on trust land sales and travel repossession laws, of which we can help in structuring.

Fifth, that there be incentives that would help boost CRA ratings. There is really a need for some incentives for banks to become interested. We have a terrible time understanding why foreign countries are given preferences when Indian nations are not.

Also, that other incentives that would help in coordinating with established Government Loan Guarantee Programs such as Farmers Home or Veterans benefits, HUD Programs.

Seventh, that supervisory agencies have proper training and understanding in Indian Reservations and their unique status.

And also that, number eight, that we be given an opportunity to comment as to the bank's activities.

So those are our suggestions that I would like to provide to this group.

Last, let me just say that we need to continue working with the Department of Justice and other agencies to make sure discrimination does not continue.

Thank you very much.

[The prepared statement of Mr. Plummer can be found in the appendix.]

Chairman KENNEDY. Mr. Vice President, I want to thank you very, very much for your willingness to come and testify this morning.

You know this is an issue that I am very, very interested in working with you to develop some solutions to.

Since I was a very young fellow, I have come and visited the Navajo Nation on a number of different occasions and look forward to continuing to work on issues that you are concerned with.

Obviously, economic development is key. I would hope that we could follow up in terms of you working with my office on trying to coordinate, both at a congressional level and, as I point out, with the regulators, so that they understand the importance of this issue and develop strategies to deal with the particular needs of the Navajo Nation and other Indian tribes around our country.

We would look very much forward to working with you.

If there are other comments that people want to make right now.

If not, I would ask the other witnesses to come forward.

Mr. McCandless.

Mr. MCCANDLESS. Mr. Plummer, one of the things that I continue to come in contact with—and I have 11 tribes in my district—is the sovereignty problem. That is very difficult to overcome when you are talking about the normal social structures of a given society, whether it be land use or whether it be the offering of services, the repossession of property, and we can go on.

I am not advocating that you give up your sovereignty. I am saying that it is very difficult for businesses to do business in, essentially, another country.

I think that is one of the key elements that relates to what you are talking about in the case you gave where you have to travel 4 hours round trip.

Obviously, it would require an investment on the part of a financial institution to provide the financial services that I think you are looking for on a sovereign nation's territory with a very restrictive window of legal availability.

So therein lies one of the key elements that would need to be overcome in the area that we are talking about.

Mr. PLUMMER. That is exactly why we feel that there should be an area within the proposed changes that would deal specifically with Indian tribes.

We find ourselves in an awkward position, as I stated earlier, when foreign governments are able to get agreements in place or even get Federal assistance to boost their economies when our Indian nations, we just don't have that ability at the present time.

And the area of sovereignty should be included in these discussions and in the changes that will be proposed in this particular law.

Chairman KENNEDY. Thank you very much.

If the other members of the subcommittee don't have any questions, I could excuse you, Mr. Vice President. If you would like to stay on at the witness table while we invite the other witnesses from the third panel up, that is your choice. OK?

Mr. PLUMMER. Well, we would like to invite you to come and visit our nation.

Chairman KENNEDY. I would love to. Please. Maybe you could drop me a note at the end of hearing.

Thank you, Mr. Vice President.

I will now ask the third panel to please come forward. The third panel is a distinguished panel and the first and foremost is a very good friend of mine, the Reverend Charles R. Stith, the national president of the Organization for a New Equality. He founded the organization in 1985. Reverend Stith has received numerous awards including from the National Urban Bankers and the Bank Educators Alliance of Massachusetts.

It is a pleasure to have you with us this morning. And we will be looking forward to your testimony.

If everyone else is settled, I might just ask Reverend Stith to grab the microphone and start his testimony. Because of the late hour and because people have planes to catch, I would ask if everybody could try to keep their remarks to 5 minutes, we could get to questions as soon as possible.

STATEMENT OF REV. CHARLES R. STITH, NATIONAL PRESIDENT, ORGANIZATION FOR A NEW EQUALITY

Reverend STITH. First of all, Mr. Chairman, I would like to commend you for the stalwart work that you have done historically to try to make CRA compliance in this country a reality.

And I would like to commend the entire committee for convening this hearing on the proposed regs.

I appreciate the opportunity to testify before the subcommittee on the proposed regulatory changes in CRA. As you have articulated so well during your queries of the regulators, reform is absolutely necessary and it is necessary because of the record of discrimination by banks toward low-income communities in general, but minority communities in particular. And this is a point of real concern for us.

When you look at the rate of business ownership along racial lines, whites own 30 times the number of businesses which blacks do. When you look at the history of home ownership, whites own homes 12 times—the number is 12 times greater than blacks.

When you look at the net worth of the average white family against the average black family, the average white family America is worth about $43,000; the average black family is worth about $4,300. And the irony of that disparity is that over the last 30 years, the membership of black families in the middle-class has grown over 300 percent.

The reason for the disparity in terms of equity and ownership has to be directly related to this issue of the lack of access to credit and capital.

There are three critical flaws that ONE and our National Community Reinvestment Network has observed relative to the present proposal.

First of all, there is a failure to significantly deal with race as a factor in determining or evaluating CRA compliance. Again, as you noted in your queries of the regulators, that while there is reference made to HMDA in the evaluation process, it is ambiguous as to how that data will be interpreted; and it is ambiguous relative to the weight that HMDA data will be given in determining a bank's compliance with CRA. And the failure to deal with race as a factor is further underscored by not requiring the collection of race-specific data as it relates to small businesses.

This, obviously, portends a problem relative to mitigating or monitoring the discrimination that takes place against minority business owners and minority entrepreneurs.

A second concern is that the ratings system is flawed. At the core of the issue of compliance is the credibility of the composite ratings system. Under the proposed regs, a retail bank, again as you noted, could do very well in terms of a grade without having a record of any achievement in terms of lending, and that is where the rubber hits the road.

Our third critical issue with the proposed regs is that community groups are marginalized in terms of their input around CRA compliance. You know, one way in which that is reflected is just in the lack of resources and capacity of many small grassroots organizations to evaluate what banks are doing, the appropriateness of strategic plans.

The component to which they are marginalized are also reflected in the fact that, while as Comptroller Ludwig mentioned, community groups would have an opportunity to respond to strategic plans, it is after the fact. And they ought to be a part of that process from the very beginning.

We have got 10 recommendations.

First the HMDA data must be used as a factor to determine market share parity under the lending tests.

Two, it is absolutely critical that there be a collection and a reporting of HMDA-like data for small business loans. And it must be mandatory for all banks.

Three, small business lending to racial minorities must be used to determine market share parity under the lending test.

Four, community groups must be given the right to appeal inflated ratings.

Five, community input should be sought by regulators, as Mr. Ludwig said, as part of the examination process but also at the onset of a development of a bank's CRA strategic plan.

Sixth, quantifiable measures should be assigned to the qualifiers to fairly measure a bank's performance. Earlier, Congressman Rush talked about the ambiguity of phrases like "very significant." It just doesn't zero in.

Seven, no retail bank which performs poorly on the lending test should be given a passing final grade.

Eight, minority hiring and the appointment of minorities to a bank's board of directors should be used as factors in a service test.

Nine, minority procurement should be used as a factor in the investment test.

And then, banks should be given credit under the investment test for the support of CRA advocacy groups.

Thank you, Mr. Chairman.

[The prepared statement of Reverend Stith can be found in the appendix.]

Chairman KENNEDY. Thank you very much, Reverend Stith, for cutting to the quick.

Reverend STITH. And you know that is hard for a preacher.

Chairman KENNEDY. Well, you did a good job, Charles.

I want to thank you for coming down and encourage you to continue the excellent work that you and your organization have accomplished in terms of actually substantially increasing, certainly in our hometown, the bank participation in lending programs and really being a national leader on this issue.

Thank you for coming and sharing your thoughts with us this morning.

Our next witness is Terry Jorde, who is the president of the Towner County State Bank in Cando, North Dakota. She is active in several local community and State affairs and on the board at the North Dakota Department of Banking and Financial Institutions.

I am looking forward to hearing your testimony.

STATEMENT OF TERRY JORDE, PRESIDENT, TOWNER COUNTY STATE BANK, CANDO, ND

Ms. JORDE. Thank you, Mr. Chairman.

I am Terry Jorde. I am president and CEO of the Towner County State Bank in Cando, North Dakota.

My bank has $24 million in assets and 12 employees serving a town of 1,500. This is very typical of the IBAA member banks that I am representing today. We appreciate the opportunity to testify.

In the near future, the IBAA, will be submitting formal comments to the agencies, and I ask that you accept these comments into the record of this hearing.

Chairman KENNEDY. Hearing no objection, it is so ordered.

Ms. JORDE. Thank you.

We appreciate the opportunity to testify.

The proposed CRA regulations respond to the President's directive to improve the CRA process in ways that "minimize the compliance burden on financial institutions while stimulating improved CRA performance." This initiative was based on the fact that CRA is one of the most burdensome and least effective regulations.

We strongly support the proposed streamlined examination process for banks under $250 million. The current CRA enforcement scheme treats large, multinational, and regional banks the same as community banks. This is unjustified. Both the banks and the markets they serve are completely different. About the only thing my bank has in common with Bankers Trust or J.P. Morgan is the fact that we both accept deposits and have commercial bank charters.

In 1991, the Financial Institutions Subcommittee recognized this fact and adopted an amendment offered by Representative Kanjorski exempting from CRA all institutions under $150 million in assets and all rural institutions under $250 million. The full committee dropped the proposal in a deal over an unrelated provision. The current proposal builds on the principle behind the Kanjorski amendment, that community banks are, by definition, committed to

serving their markets while maintaining the requirement that all institutions comply with CRA.

Community bankers strongly support the goal of CRA. Many community banks serve low- to moderate-income residents since they make up the great majority of our market. This is where we work and live. CRA, as it is presently administered, detracts from banks serving these communities by emphasizing a paper trail rather than ongoing lending performance.

The proposed streamlined examination process for banks under $250 million in assets is consistent with the legislative history of CRA. The committee reports and floor debate do not indicate any intent to require that all banks undergo an identical enforcement scheme. And the legislative history makes clear that the act was not intended to require banks to do any additional paperwork. The agencies' proposal is completely consistent with this by significantly cutting back the paperwork requirements for smaller banks.

We believe a tiered system is consistent with President Clinton's request for CRA improvements. On July 15, he said a CRA "system which is too inflexible to recognize the real differences among the circumstances in which our banks and thrifts operate, would poorly serve both our financial system and our communities." Currently, banks with staffs of 10 are being asked, and are expected to do the same as those with staffs of thousands. The proposed CRA revisions differentiate between multinational and regional institutions serving large, metropolitan areas and the community banks serving small towns and rural areas.

The $250 million streamlined examination process is not an exemption. CRA examiners will look at a community bank's actual lending record to determine if it is serving its community.

The streamlined examination system has a serious flaw, however. To gain a satisfactory rating, a community bank must have a 60 percent loan-to-deposit ratio. A fixed ratio fails to account for differences among local markets and for the ebbs and flows of activity within markets.

Many areas lack sufficient loan demand, making it impossible to meet an arbitrary 60 percent test. In addition, many markets, particularly rural areas, experience significant seasonal variations. My bank's loan-to-deposit ratio ranged from 44 percent in January 1993 to a high of 65 percent in September. It is now just under 50 percent.

And I might add, it is 28 below zero too. Nothing grows at that time of year.

Because of these factors, half the banks do not meet the 60 percent test. It is makes no sense for examiners to impose and then require thousands of banks to demonstrate that a lower ratio is reasonable.

A loan-to-deposit benchmark also ignores much of the bank's community reinvestment activity. Loans that banks originate and sell into the secondary market help our communities, but do not show up in the ratio.

Similarly, community banks effectively lend to local municipalities for infrastructure development by purchasing municipal bonds. These are not counted as loans. The banks also make considerable investments in collateralized mortgage instruments and mortgage-

backed securities. These investments allow banks to support long-term home lending without paying long-term interest rate risks.

If the proposed 60 percent loan-to-deposit test were adjusted to take these factors into account, these bank's loan-to-deposit ratios would rise significantly.

We are also concerned that the proposed CRA regulation could become an artificial incentive for banks to reach to make loans that they should not make. This is unwise and unnecessary. Many bankers have told me that they wish that there were more opportunities to make more sound loans in their markets.

Because of these factors, we recommend that the regulatory agencies drop any reference to a specific loan-to-deposit ratio.

Though some have argued that the $250 million asset level encompasses too many institutions, it only applies to around 16 percent of the banking industry's total assets. Many community banks above that level operate with small staffs and have an intense local focus.

Therefore, we recommend community banks up to $500 million in assets have the option of being examined under the tiered system. This would only increase the level of assets covered to approximately 19 percent.

We appreciate the opportunity to assist you in your review of the proposed CRA regulations. We strongly urge you to support the tiered examination system.

Unless community banks can get a break from the current heavy burden, they will find it increasingly difficult to continue serving their communities. And that would truly undermine the goals of the Community Reinvestment Act.

Thank you for the opportunity to comment.

[The prepared statement of Ms. Terry Jorde can be found in the appendix.]

Chairman KENNEDY. Thank you very much.

Our next witness is Allen Fishbein. He is general counsel for the Center for Community Change, and director of the Center's Neighborhood Revitalization project, which aids low-income and minority community-based organizations.

Mr. Fishbein has been involved in this effort for over 14 years and has provided legal representation for the first successful challenge to a bank expansion application under the CRA.

We want to thank you for all the hard work you have done on behalf of lower income people and people of color in our country, and thank you for coming and testifying today.

STATEMENT OF ALLEN FISHBEIN, GENERAL COUNSEL, CENTER FOR COMMUNITY CHANGE

Mr. FISHBEIN. Thank you, Mr. Chairman. And it is a pleasure to be here and on this distinguished panel. And I want to commend you for your continuing leadership in this area and the involvement of the subcommittee because we need you.

Last July, President Clinton directed the agencies to make good on his promise to turn CRA into a more performance-oriented regulatory system. And the proposal that was unveiled last December, we think, represents an important downpayment on making good

on that promise. It provides a framework for a more intelligent performance-oriented rating system.

We believe that it also contains some important flaws, some of which, if not corrected, would actually represent a step back from existing regulatory practice.

Also embedded in the proposal are a number of issues that are raised which need to be addressed in the final regulation for the purposes of greater clarity and to guard against unintentional consequences. We believe that these are all fully correctable through the rulemaking process and hope that they will be addressed. But, at the same time, we encourage the subcommittee to play a close role in monitoring and oversight of the rule.

You pointed out, Mr. Chairman, in questions to the previous panel, about the need for reform being ongoing. And I think you said that quite well and quite directly. And certainly our research seems to indicate that, in the past year, rating inflation seems to be creeping back into the regulatory process and emphasizes the need to develop a new more rationalized scheme. We think the proposal represents an important step forward in several years.

First, as I said before, it provides a framework for performance-oriented ratings system, particularly through the lending test. And the heart of that is the comparative market share analysis.

And I must say, I was a little disappointed in the comments from the regulators to hear what I think is backpedaling on the importance of that market share analysis because it is the one really objective measure in this proposal which is intended to be performance oriented.

Because, number one, it compares a lender against itself. It looks to see whether a lender is equally active in all parts of the market. It compares a lender against how it is performing in the context of other lenders, because it looks at their market share throughout the communities that they are serving. And while we don't know it is perfect, we think it is a good starting point. The deletion or the minimization of that test would really leave very little left of this new performance-oriented system.

Second, the disclosure of loan data is an important step forward. The progress on the HMDA, which you were responsible for expanding significantly, shows that the disclosure of loan information, in and of itself, is a powerful tool for driving changes in banking practices. And we certainly hope that the final rule will include race, gender, and ethnic data for small businesses as well.

And the third item is the use of supervisor powers, under certain circumstances, which has been a change and glaring omission in the regulatory scheme up until now, and we commend the administration for proposing that.

Four, having listed some of those positive steps forward, let me spell out some of the critical concerns we have with the proposal.

Number one, we continue to have too much emphasis on activities other than direct lending. As you pointed out, a lender can receive an overall satisfactory rating even if it has failed the lending department, if it scores well on the investment and service test. We think this was wrong. CRA was established primarily for credit access, and we think this imbalance ought to be corrected in the final rule.

Second, the small bank exemption, we think, needs to be addressed in the final rule. Under the guise of what is being described as streamlining, the proposal would exempt the overwhelming majority of banks in this country from any meaningful coverage.

And let me suggest that under the rules or the screens that they are proposing, it is entirely possible for small banks to do virtually no lending in barrios, or to significant African-American segments, perhaps of a local or rural community and yet get a satisfactory or perhaps outstanding rating on their overall CRA evaluation.

We think this is inadequate, and there is no justification for it under the statute. And it needs to be deleted in the final rule.

Also I would say that the rule seeks to narrow discrimination in the evaluation process. Race, in many respects, is decoupled from the CRA evaluation process except in very limited situations. We think that is wrong and it needs to be addressed.

The backdoor safe harbor is a fourth item I would mention. I think it is unnecessary in the proposal. It would mean that the public would have an ability to comment on corporate expansions in only a handful of situations in America, when we know that the richness of that comment during the expansion application process has arguably been the most important wheels and mechanism of the CRA enforcement process.

Let me conclude, by saying that we think that the proposal offers great potential; but many issues need to be addressed before we can say with any assurance that the rating system would result in a system that would command respect from all parties, number one; or two, would likely result in increased lending to underserved communities.

And one final note, Mr. Chairman. The regulation places a heavy emphasis on community groups to be active monitors, to comment, to follow activity.

But one of the questions that didn't get addressed in this proposal or, for that matter, in the President's budget—or virtually any aspect of funding—is to provide expanded resources for community groups to do this work. Most of them are operating on a wing and a prayer with very limited resources; and if they are expected to play a very substantial, ongoing, and meaningful role in the evaluation process, we think expanded resources have to go arm in arm with helping that occur.

Thank you very much.

[The prepared statement of Mr. Fishbein can be found in the appendix.]

Chairman KENNEDY. Excellent point, Allen. And I appreciate your testimony.

The next witness is James Culberson, who is presently the chairman of the First National Bank and Trust Co., of Asheboro, North Carolina.

He first joined the bank in 1974 as president—not a bad way to start—and chairman and chief executive officer.

Mr. Culberson has been active in several banks' organizations and is currently on the boards of directors of the American Bankers Association.

Thank you very much for joining us today. We are looking forward to your testimony.

STATEMENT OF JAMES M. CULBERSON, JR., CHAIRMAN AND CEO, FIRST NATIONAL BANK & TRUST CO.

Mr. CULBERSON. I am delighted to be here with you today and to discuss with you the CRA proposal. The proposal we are here to discuss this morning would make sweeping changes in CRA regulation. Some of those proposed changes are good, others are not so good.

First the good news. The proposal takes a very positive step by recognizing that one size does not fit all.

Today's approach is particularly hard on community banks which have significantly less capacity to cope with the massive documentation required.

A streamlined examination process for smaller banks will free up scarce resources for more productive uses in the community, and it will be welcome news to both bankers and bank customers.

I know that some consumer advocates characterize the streamlined examination as an exclusion for small banks. That is simply not true. "Streamlined" is not a code word for excused. Small banks would have the same obligations they have today to meet local credit needs, but they would not be required to document their every move.

Another positive element is the menu approach; one that offers different options for demonstrating CRA compliance. Also positive is the specialized institutions, like credit card and wholesale banks, would be able to meet their CRA obligation in additional ways compatible with their type of business.

However, I must tell you, Mr. Chairman, that we have great concern about many elements of the proposal, not only about how they may be implemented in 1994 but also what they may become in future years. We have seen well intentioned laws and regulations turn into nightmares before.

CRA is so open ended that our industry must be concerned about ever increasing costs and it has potential for slowly but surely substituting government and political control over the credit decision process.

We have serious concerns about the proposal's new reporting requirement for all banks over $250 million in assets.

Mr. Chairman, my bank has approximately $250 million in assets, and I can tell you how the additional reporting requirements will affect me and my customers.

It will raise the cost of each and every small business, small farm, and reportable consumer loan I make and do absolutely nothing to improve credit availability.

The data will not tell you much about the credit conditions for small businesses, farms, or consumer borrowers. Banks are not the only source of these loans. Finance companies, credit unions, and other lenders do not report their lending activities. The omission of these players would simply give an incomplete picture of what is happening in these markets. The added reporting should be eliminated.

A related concern is that the cutoff for the streamlined exam is too low. Today, a market for a $250 million bank is not very big. Banks like mine are doing a good job meeting the credit needs of their communities and should have no difficulty demonstrating that fact under a streamlined examination process. The $250 million threshold should be raised.

We are also concerned that the proposed 60 percent loan-to-deposit ratio test is unrealistic. Many smaller community banks will find the 50 percent ratio inconsistent with sound business practices.

Moreover, many market areas do not have sufficient loan demand to generate a 60 percent loan-to-deposit ratio. The 60 percent test is simply not a good indication of how well a community bank is meeting local needs.

Another important issue is credit allocation. We are concerned that the phrase, quote, performance over paperwork, end quote, is being interpreted to mean that specific bank loan targets should be set for low- and moderate-income borrowers or for certain geographic areas. This is credit allocation pure and simple.

Moreover, the proposed market share test may inadvertently result in credit allocation by requiring that a bank's market share in low- to moderate-income areas be equal to or greater than the bank's market share in the remainder of its market.

There may be tremendous pressures on banks to lower their underwriting standards in order to achieve—to meet this test.

I would like to add one final point, and that is the continued exclusion of credit unions and other financial service providers from CRA.

Two of my biggest competitors are credit unions. Both are larger than my bank and federally insured, and yet they have no CRA responsibilities. Community bankers find incredibly frustrating that credit unions, security firms, mutual funds, insurance companies, and the farm credit system do not play by the same rules. How can this be justified?

Mr. Chairman, a great many questions remain about how to make CRA work better. Some parts of the regulators' proposal seem to move in the right direction. Others are entirely at odds with efficient and effective CRA reform. ABA's Government Relations Council will meet later this week to discuss the proposal in more depth, and we will file a detailed comment letter with the regulators.

There are many examples of bankers, community groups, and local governments working together to solve local problems and to build a better future. We all need to work together to have a fair and reasonable structure for the administration of CRA.

Thank you very much.

[The prepared statement of Mr. Culberson can be found in the appendix.]

Chairman KENNEDY. Thank you, Mr. Culberson. I will be happy to work with you to extend CRA to all those other institutions as well.

I would now like to introduce Bertha Lewis, who is the director of ACORN in New York——

Ms. LEWIS. You can promote me. That is fine.

Chairman KENNEDY. That is fine with me. She directs ACORN's loan counseling activities and has extensive underwriting experience. We thank you for joining us and we are looking forward to your testimony.

STATEMENT OF BERTHA LEWIS, DIRECTOR, NEW YORK, ASSOCIATION OF COMMUNITY ORGANIZATIONS FOR REFORM NOW

Ms. LEWIS. Good morning to you, and I am glad you have landed.

I would like to say good morning also to the remaining members of the subcommittee. And I appreciate this opportunity to testify before you today on behalf of ACORN.

ACORN has supported the President's stated goal of strengthening enforcement of CRA and focusing CRA evaluations on performance rather than process. But we are sorry this morning to report to you, therefore, that unless these proposed CRA regulations are substantially strengthened, they will result in less, not more, community reinvestment in neighborhoods like the one that I live and work in, in Brooklyn, New York.

In their current form, the regulations do not represent a net gain over the status quo, And for some communities they represent a loss.

While we have great respect for Comptroller Ludwig's efforts, we have to say that we are deeply disappointed in the lack of political will that the administration has displayed to date. Even more banks are getting passing CRA grades under the new administration than under the Bush administration, and does anyone really believe that 93 percent of the banks in our country are doing a satisfactory or outstanding job of community reinvestment?

I know I don't believe it, and I don't think that most of the subcommittee does either.

The administration's major bank initiatives, such as interstate branching and regulatory consolidation, contain nothing for consumers or communities, and the regulators are backpedaling from the CRA plan in response to industry criticism. They are backpedaling so fast you would think you are watching a video in rewind.

We have heard a lot about how the Fed is undermining CRA reform, and that is the truth. But there is no reason why the other three agencies can't put out a strong regulation on their own. We would rather have a strong regulation from three agencies than a weaker CRA from all four.

Now, I have attached to my testimony today a briefing paper on the new CRA regulations which lays out 16 specific changes that are desperately needed. The regulations do have some positive features, including the market-share methodology, public disclosure of small business and underlending, and greater clarity about the enforcement powers of the regulatory agencies. But these improvements are overshadowed by the glaring flaws of the proposals which include, first, the ability of banks to buy out of CRA, through investments in community development banks or other investments.

We cannot allow banks that redline to get satisfactory CRA ratings by creating an investment loophole. We don't want a separate

and unequal banking system; one that is for the poor and minorities and another one for everybody else.

The bottom line is, no bank that fails the lending test should get a satisfactory rating, period.

Second, the implicit safe harbor provision. The new system still relies on the subjective judgments of examiners. And examiners are often wrong and ill-trained. My community should not pay the price for regulatory failures. And I should add that while the administration may deny that there is a safe harbor in the proposal, the Fed thinks that the regulation does create a modified safe harbor. And the Fed decides most bank applications.

While the regulation does create a safe harbor for bankers, they don't deal with the main problems that community groups have identified with CRA over the years, mainly that the agencies, especially the Fed, deal with challenges in a hostile, closed, and secretive manner. Merger applications almost never trigger public hearings, comment periods, or denials, even when they involve many States and they are protested by many community groups. Either this portion of the rule should deal with the—how the agencies deal with merger applications or it should be totally deleted.

Third, the exemption of small banks from CRA. These are the very banks that have done the worst job at CRA over the years.

Fourth, the rule rewards gentrification, which is a major problem in cities like New York. Banks will actually get CRA credit for loans to high-income people that come in and displace low- and moderate-income families.

Fifth, despite appearances, the rule actually lowers the rate given to racial discrimination in CRA exams. While the regulators will give a bank that is in violation of lending law an unsatisfactory rating, the regulators never find such violations. And what banker would be stupid enough not to correct such a problem before a CRA exam?

The rule should be changed to let examiners take into account any evidence of discrimination such as disparities in rejection rates for loans, low levels of applications from minorities or biased underwriting guidelines.

Sixth, the proposal creates a secret appeals process for bankers that is not available to the public.

Seventh, no guidance about strategic plans would be evaluated by the regulators or how they would respond to community challenges to such a plan. The strategic plan could become a massive loophole for savvy bankers, and we know they are pretty savvy.

ACORN would prefer that CRA be strengthened through the regulatory process; however, if the key problems raised by the proposed rules aren't fixed in the final rule, we will not circle—we will land and approach Congress with legislative proposals to undo any significant damage that may have occurred.

Historically, Congress has done a much better job with CRA than have the regulators, in part because Congress is a little bit more in touch with our communities, and a little less cozy with the industry. Until the regulatory process runs its course, however, legislation in this area would be counterproductive.

Again, Mr. Chairman and members of the subcommittee, I cannot emphasize enough how important CRA is to our communities.

In New York alone, I have witnessed a revolution in the practices of the industry with regard to home mortgage lending, resulting in unprecedented opportunities for credit access and economic opportunity for thousands of low- and moderate-income families and they have not lowered their lending standards one iota.

We hope that these oversight hearings will contribute to a stronger and more effective CRA. We may need to call on your leadership again, Mr. Chairman, if we find the regulations to still be inadequate.

Thank you and that concludes my statement.

[The prepared statement of Ms. Bertha Lewis can be found in the appendix.]

Chairman KENNEDY. Thank you, Bertha. We appreciate your comments this morning and look forward to working with you over the course of the next few months as these regulations are, I hope, refined.

Our final witness this morning is Gale Cincotta. She is the cofounder and serves as executive director of the National Training and Information Center. She has been a leader in the neighborhood movement for many years. She was appointed by President Carter to the National Commission on Neighborhoods where she chaired the Reinvestment Task Force.

We have worked a little bit—not as much as maybe I had hoped—in the past together, and I am looking forward to your testimony and to working with you in the future.

Gale.

STATEMENT OF GALE CINCOTTA, EXECUTIVE DIRECTOR, NATIONAL TRAINING AND INFORMATION CENTER

Ms. CINCOTTA. Thank you. I am very glad that you were able to hold the hearings, and where I am going, all the flights are canceled, so we can stay here all that you want. Nobody wants to eat lunch.

It is good that someone in the Congress is holding hearings on what the regulators are trying to do. I commend Mr. Ludwig for trying to do something, but in trying to pull together all the four regulators, you worry that you will end up with the lowest common denominator rather than the highest standards of what should be done to improve the CRA process.

When I look back on the history of community reinvestment, in Chicago in 1972, we got a city ordinance that had business loan and housing loan disclosure based on banks wanting to be a depository of city funds. Somehow these banks have figured out a way since 1972 to disclose housing and business loan data by census tract.

Former Mayor Daley announced at our first conference, where we pulled community groups together across the country, over 2,000 groups came together and formed National People's Action. The main thrust that came out of that conference is that we should go to Congress and get legislation so that all the financial institutions across the country report to all the folks across the country on where they are making their loans.

We wrote the bill on the church floor and on scratch pads. It was called the Financial Institutions Reporting Act. Taking it to Con-

gress, we lost business loan disclosure by about one vote under Senator Proxmire at that time. What we did win, was disclosure of mortgage loans and that became the Home Mortgage Disclosure Act.

We have spent all our time since then trying to get business loan disclosure included. We have heard every argument on the books of why you can't deal with it, why it can't be brought in at least as Ludwig's proposal is talking about business loan disclosure.

Twenty-some years later, we will hang around to make sure we get some form of it.

I thought—our thought is that, one, there should be no safe harbor for any of the financial institutions. In no way can they opt out under any circumstances on what they do.

Going back a little bit, we don't think that—let me say it this way. We feel all banks that disclose under home mortgage disclosure should disclose business loan data. Requiring only banks that have $250 million in assets is ludicrous. If all these banks have been able to figure out how to disclose housing loans, they should be able to disclose business loans.

In hearing Mr. Ludwig talk about his father and wanting a loan so he could go to school to become a doctor, I thought about my parents who had a small restaurant, and the only loans that they could get were from suppliers. So that if you are the person who brought in the meat or the canned goods this was where you got your loans.

When Congressman Kanjorski held hearings on the possibility of a secondary market for business loans, what people there were testifying is that now it is not a loan that you get from a supplier. The small business people have to have a credit card or put a second mortgage on their home to get a loan. And when I talk about small businesses, we are talking about small businesses—the grocery stores, drug stores, cleaning establishments, and so forth.

So I think small business, by one definition, is very different from what we think it is going to take to rebuild our neighborhoods across the country.

One of the comments I heard here was that race data was not going to be available, and what I would like to recommend, just like now the home mortgage disclosure didn't give you race data, but when you brought in the FIRREA data, we got the race data on the housing loans through that. Probably, what happened is that the Fed and the regulators used that to pull the public's access to the data away for a year.

Where we usually got the HMDA data March 31, they said we are going to mesh something that didn't mesh. The danger in doing this together would be that the Feds, again who have tried to sabotage everything year after year after year, would do it again; so I would suggest that if we get the business loan disclosure like we get the home mortgage disclosure—and under like FIRREA you would get the race data and under orders that the Feds would let the data on business loan and housing data come out on time—and then separate that when they get this other data under your direction, so we don't get into the same problem we have. We still don't get access to the data by March 31.

I know it is turning red over there.

Safe harbors, I think, should be absolutely out. Again, I think, there should be bump-ups for investments. It is like again you are trying—I think selling this to try to get everybody to agree to the proposal. And you hear here, the banks aren't going to agree, even with what Ludwig and the other regulators have agreed, you hear the bank executives saying, we don't like it anyway. These are the same folks that, when we tried to get business loan disclosure in the State of Illinois, and had meetings with them over and over again in our office—we went down to the hearings trying to come up with some agreement—fought it, fought it and killed it.

So I think that, again, bump-ups for investments is very, very scary because we need regular business loans coming into our neighborhood. We don't need a buyout where somebody can dump a couple of bucks in a CDFI and get rid of their obligation to provide direct loans in the neighborhood.

We need the banks to operate in our communities. We need the trade associations maybe to stay out of the discussion. And maybe you could get some bankers here who would tell you that with us, and we can agree with some of the bankers, the regulators have screwed up this process so bad. We don't want a room of paper; the bankers don't want a room of paper. We want loans; hopefully, they want loans. And I think Ludwig is trying to get it where you don't have to have a bank have a room of paper. A room of paper does us no good.

You have to have cross-training, all the regulators together, all the safety and soundness, as well as the regulators that are looking for discrimination on the data.

Chairman KENNEDY. Well, I——

Ms. CINCOTTA. I will stop it there, but I know the time is—I would like to talk longer. As you sit and listen to all the other folks, you start writing yourself more notes.

[The prepared statement of Ms. Cincotta can be found in the appendix.]

Chairman KENNEDY. Gale, I do appreciate your testimony and your directness.

I would like to deal with what I consider to be the heart of the political problem that we are facing here as well and I think that Ms. Jorde really makes what appears to sound like a very reasonable case. It is especially relevant if you don't represent a district like mine which is 40 percent black, brown, and yellow and very, very poor, as Charles can tell you.

If you are a Member of Congress and you listen to Terry's testimony, she says she comes from Cando, what a great name for a town, Cando, North Dakota, and there are probably not a lot of blacks, browns, and yellows in Cando, North Dakota. Maybe there are a few Indians, but I don't know. She would say that they are out there doing the best they can. They want to make loans. They want to take care of everybody in the community. Terry, what is your bank rated?

Ms. JORDE. As far as account rating?

Chairman KENNEDY. No, your CRA rating.

Ms. JORDE. We just had a CRA exam in December and received for the first time an outstanding rating.

Chairman KENNEDY. So she has an outstanding rating and she comes up here to Capitol Hill and says, hey, why should we have to go through this? What is all this about? Isn't there some reduction in this paperwork? Can't we somehow deal with the fact that in our particular part of the country this is just not an issue? Why don't we let Gale and Charles speak to these questions.

Ms. CINCOTTA. One of the things we talk about in the testimony is that all the regulators should, and their enforcement officers, should have the demographics, when you go into some area you have the demographics of race and ethnicity, if they are farmers, if they are built up cities and where other banks are located; what is the story there and that all the regulators should have cross training on that.

So if you go somewhere maybe in Minnesota or North Dakota you are looking for farm loans, you are looking for other things that you might not have in the city. I think that folks can be trained to do that. We used to, all of our groups, years back, do this kind of training. It was all stopped after the first couple of years. But some sense of what are you walking into? What are the other institutions? What are the credit needs of the area? Who is there? So it might be that there are farmers in the Indian Nation as well as some smaller urban areas. In Chicago, New York, it is another story. But that has not——

Chairman KENNEDY. That is certainly not——

Ms. CINCOTTA. You could do it, I could do it. The regulators.

Chairman KENNEDY. I am agreeing with you. I think that is so much more sophisticated than the way the regulatory structure exists.

Ms. CINCOTTA. They get paid a lot of money. There are hundreds of them now. There is going to be more. How about we give them some lessons in smarts? You travel around the country. We do. You would know. I would know. Why can't they know if they really wanted to know?

Chairman KENNEDY. It is a good point. Charles.

Reverend STITH. Last year, Congressman, in April we held an economic summit here in Washington, DC, and one of the participants on the panel that was a part of the deliberations was Bill Brandon, the president of the ABA, and he raised the paperwork issue over against the issue around reporting of race-based data for small businesses. And we said to him at that time we would be willing to sit down with bankers anywhere in this country to try to come up with something that was mutually agreeable around the issue of paperwork reduction. As Gale said earlier, we don't want a room full of paper. They claim they don't want a room full of paper. But I am going to tell you, I am beginning to believe the argument is a straw man. We have not been able to get together with folks to talk about this issue in a substantive way, and the more I hear the concern, the more I am inclined to interpret it as not a concern about a reduction in paperwork but rather a reduction in the responsibility to be held accountable on this issue.

Chairman KENNEDY. Well, I certainly understand your frustration, Reverend Stith. I don't know if Mr. Culberson, might be willing to address that. Were you just sort of parachuted in here by

the ABA? Any particular quality of yours that enabled you to get this distinguished opportunity?

Mr. CULBERSON. And the parachute landed. I am cochairman of the Government Relations Council for the ABA.

Chairman KENNEDY. I don't know if you might be willing to sit with Reverend Stith and see if there might be some way to come to grips with some of the concerns that both of you have raised. I know he runs a very important organization that has been very involved in these efforts. Maybe you could see whether or not there might be some areas that you could agree upon.

Mr. CULBERSON. I would be more than happy to. I would like to make a comment, if I may, on that subject.

Chairman KENNEDY. Sure.

Mr. CULBERSON. Under FIRREA, the Fed was required to get reports on small business and small farm lending and their first report was just issued in December of this year. And in that report, it states that there were 6,400 banks that made business loans, virtually all the business loans, of under $100,000. That was $73 billion outstanding on September 30 of last year. But significantly, it showed that there was a 6 percent increase in those loans in 1 year. So there were a lot of loans made in a year when the general reports were that business loans were down.

They surmised in this report the reason for loans being down was restructuring of large loans and that sort of thing, but, generally speaking, there were lots of small business loans.

Second, I would agree with Ms. Cincotta that I don't know what the definition of a small business is either. I think the barber shop and the beauty shop and the grocery store are small business loans but those numbers seem to go up and down. There is no real fine definition on it.

Finally, I would say that despite what others may think, bankers are very serious about their communities. We make our living there. That is what it is all about. Granted, we are not perfect, and I think there have been some positive things that have come out. We have learned some things that we need to do a better job, but overall we are very concerned about our communities, about housing, about loans, and there are laws on the books about fair credit and discrimination and those are serious laws and we take them very seriously because there are some strong penalties for them.

Chairman KENNEDY. Nobody questions the general commitment. I think what Bertha was trying to say to you, Mr. Culberson, is that the fact is that there is, we have noticed, not only in the business community but certainly in the government, a lack of understanding by, in many cases, a lot of wealthy white men to the needs of poor minority men and women. Those issues sometimes take an awakening to understand the kind of concerns that actually exist in a country that is as diverse as the United States. That is where I think there is going to always be kind of a rub. I think that what we are trying to do is say that it isn't going far enough. When we look at the actual underlying data, there really is a statistical demonstration of prejudice that exists in these kinds of loans. For instance, on the home mortgage loans, if you look at nationwide data, if you look at city by city, if you look at census track by census track, if you look at individuals of different racial or eth-

nic backgrounds coming out of the same neighborhoods with the same income levels, there is a problem. What we are talking about is how do we solve this.

I want to ask one last question. I have always been somewhat confused about how to apply CRA to, say, the Beverly Hills Savings Bank, if it even exists, or to, say, one very large bank in Boston that operates as a trust company, and has very little opportunity to make home mortgage loans or small business loans. It has always seemed to me to be reasonable to think that what we could do is ask these institutions to adopt other communities, to participate in funds, loan funds and the like. It bangs up against the notion that we want these banks to be in the business of making the loans themselves and therefore we don't want to give them the opportunity of a buyout.

I am not so instinctively upset about a buyout. I am more worried about whether we get the loans into the community. I want to throw it out and maybe, Allen, you can tell me what your concerns are about doing buyouts in general? Also, what is your sense about where you might draw the line?

Mr. FISHBEIN. Well, let me answer that question this way, Chairman Kennedy. I think the proposal very intelligently attempts for the first time to separate out how a wholesale or special purpose bank meets its CRA obligations compared to retail institutions and I think that make a lot of sense and I think most communities would agree that looking to banks that do not have retail presence, do not collect consumer deposits or make consumer loans, to look to their investment activity and community development financial institutions and loan funds, to look at the way they help provide services or buy loans as a secondary market for retail banks makes a lot of sense.

Because we think that in the retail bank area, the emphasis really needs to continue to be on lending because what is at stake here is putting an encouragement factor into retail banks, learning how to lend in areas they are not serving very well. In some ways the easiest thing for them to do is to write a check, to look at some number at the end of the year and say, I have to pass my CRA exam, how much is it going to cost me.

Chairman KENNEDY. Is that so bad? Gale, maybe you could just address that?

Ms. CINCOTTA. I think you are talking about, we are talking about banks according to their size. That all banks could buy out with a little bit of money to a CDFI, who incidentally may or may not work, or some other different thing, maybe a bank being in a bank consortium where $50 million is needed, but it came together with a lot of banks putting the money together so the banks are going to get the money out.

But I am—we are really worried about buyout of where you want the bank to be in the business of lending money. They are in that business except where we live and who we represent. Somehow they have figured out how to do this other stuff. So that trying to get the bank and all their services to come in to deal with all the folks who are pushing them to do that, sometimes as I said, special loan pools. But what this reflects is they could just dump some money and buy out of the process of dealing with the community

as part of regular business. Dealing with the community as a whole not only on lending but services, and access in the neighborhood is needed so you don't have a split community.

Chairman KENNEDY. I am interested——

Ms. CINCOTTA. There are those who don't know what a bank is.

Chairman KENNEDY. I agree with you, Gale. When all is said and done, if we have got 13,000 banks in this country with substantial compliance. You have got a phenomenal number of them that are getting these satisfactory and outstanding ratings, right?

Mr. FISHBEIN. Right.

Chairman KENNEDY. You know they are not making the loans in those neighborhoods. They are just not doing it.

Ms. CINCOTTA. The regulators have never made them. Instead of figuring out how to make them, they come here with another buyout.

Chairman KENNEDY. I know. Do we really care whether or not Mrs. McGullicuddy gets her loan from the Shawmut Bank versus some other bank. I don't really care.

Ms. CINCOTTA. Mr. Chairman, let me ask——

Chairman KENNEDY. The bank makes the loan, you know, puts the money up and Ms. McGullicuddy ends up getting her loan if she qualifies, right?

Ms. CINCOTTA. No, you are talking about dual financing for people, and it is the same argument we have been hearing on the proposal on the CDFIs. We are talking in the city of Chicago where the whole west side, for miles, and the whole south side don't have financial institutions so somebody is going to anoint somebody or put a CDFI there. We are now trying to get all the banks there, downtown banks, and everybody dealing with those communities. If you put—anoint a CDFI or a group or a credit union that may be only $1 million, dump some money, wash your hands. That is not how business should be done in the financial—work should be done in our communities. It is getting very scary because what I see with the city and these, by CDFI, and these buyouts, we are talking about the war on poverty with a nickel and where we move to getting the badges, their brains, their part of the planning in our community, they are going to dump it on one of us nonprofits to do and that is not the same thing. It is just really wrong.

I know you sound frustrated on this point but it is the same kind of stuff, let them do their business which equates to we really don't——

Chairman KENNEDY. If what you are saying worked, Gale, I would be less inclined to sort of get my back up on it. I just don't see that these banks are doing it.

Reverend STITH. Mr. Chairman?

Chairman KENNEDY. Yes.

Reverend STITH. I would—sometimes I believe it is possible to work so hard that you don't even realize to the full extent of the benefits of your labor, you know, as a result of the very aggressive work that you have been doing in the city of Boston, the Bank of Boston, for example, from 1991 to 1992 did three times the amount of mortgage lending to African-Americans in 1992 than they did in 1991, and they wound up with a declination rate that was actually a few percentage points higher for whites than it was for blacks.

Now, if you had asked the Bank of Boston before 1989 if that were possible, they probably would have argued: One, that the business wasn't there; two, get me some quick way to buy out of this and let us go on doing with what we have been doing. And I think that we cannot underestimate the very cutting edge work of folks like yourself and other folks on this subcommittee and the kind of initiatives that you put in to policy that really do begin to make a difference. I mean, that is the backdrop against which we are working. It is not as hopeless as it seemed 4 years ago because we have seen that the—Governor Lindsey talked about the light hand of government and I think he misspoke himself, yes, it has been the light hand of the regulators but it has been the swift kick of folks like yourself who helped to make a difference.

Ms. LEWIS. Mr. Chairman, if I may make one brief comment. The spirit of CRA was to integrate lending in every day operations of all lending institutions. We cannot countenance in any way, shape, or form a separate but unequal banking system. We are going to create ghetto banks. The work that Reverend Stith has referred to in the long term will benefit not only Mrs. McGullicuddy, but her son and her son's son and her son's son's son for generations. We have changed banking forever.

When you say that a retail bank who gets the same deposits from these working class people does not have to directly lend back to them, I think it is ludicrous and we destroy CRA entirely. Maybe there is room for compromise. We need to talk about possibly wholesale banks being able to do some investment but it must not be allowed for retail banks. The long-term value of what we have done and the committee and my organization and organizations like Reverend Stith's in underwriting have made those results, have made those results and have not—this is good business and unless we support banks and say, you know what, it is not going to happen in 1 year. It is not going to happen in 2 years but you are going to see that low- and moderate-income people are the largest market in this country. How can we therefore say, OK, folks, let's put you over in one little category, unless the large and the small banks that do retail business in our neighborhood change their underwriting, unless the secondary market changes its underwriting as well as the insurance industry. Then we are giving them a safe way out. Then we are saying CRA doesn't matter.

Let me tell you something, I talk to bankers every day and you know what? They think this is a done deal. Champagne is being ordered. Cocktail parties are being planned. Bankers feel as though now they are out of the cold and community groups are feeling a chill not only in the temperature outside but in underwriting. This is happening. It is happening now. Because they are gearing up to set up their ghetto banks. This is why we have got to fight it and we have got to fight it vigorously.

Chairman KENNEDY. Well, I want to say that I appreciate all of the witnesses' testimony. If you have additional comments that you might choose to make, please feel free to submit the additional comments in writing. The record will be kept open for a period of 4 weeks from today so that those views might be heard.

I do think that this was a very helpful and active panel, and I thank you all for coming forward. Thank you for agreeing to work

with us so we can fashion some good comments for the regulatory changes that have been proposed, and good legislation if need be. Have a great day.

Ms. CINCOTTA. Could I make one last comment?

Chairman KENNEDY. I am sure you will.

Ms. CINCOTTA. We have—we have all fought through the Reagan and Bush years to keep this and make it better. Our group, our organization has gotten over $12 billion in CRA agreements, that if under the new administration we don't gain but we also lose and it gets worse and our communities are tagged a certain way, this would be unbelievable.

Chairman KENNEDY. I hear you, kid.

Ms. JORDE. Mr. Chairman, may I just add 1 more minute. All I got to tell you is what my bank rating is. I think it is really important as we look at all of these issues and we consider the problems with CRA, and apparently there have been some benefits, too, from some of the testimony that we have heard, but that we be very conscious of how CRA will affect the communities, how banks will look at going into low- and moderate-income areas.

In North Dakota, as you pointed out, in my community, we have no choice; CRA is banking. It is pure and simple. We have three out of five of our directors that serve on our Economic Development Board. Our staff of 12 puts in hundreds of hours. Without that, without our community being strong, we wouldn't be there either, and if we encourage regulation or amendments that scare banks away from being in those areas, for example in North Dakota in the 1980's, a large Minneapolis-based holding company sold 27 banks located within agricultural areas because ag was not good at that time. That didn't help the communities. It doesn't help the farmers or the consumers in those areas. We have to make sure that we remember that side of the story.

Chairman KENNEDY. Thank you very much. I want to again thank all of the witnesses for your testimony. You have a great day now. The subcommittee is in recess.

[Whereupon, at 1:38 p.m., the hearing was adjourned.]

APPENDIX

February 8, 1994

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ONE HUNDRED THIRD CONGRESS

ROOM 604 O'NEILL HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

Statement
by
Representative Joseph P. Kennedy II (D--MA)
February 8, 1994

BEFORE I BEGIN A FORMAL OPENING STATEMENT, I'D LIKE TO ACKNOWLEDGE FOR THE RECORD THAT THE RANKING MEMBER OF THIS SUBCOMMITTEE, MR. MCCANDLESS, HAS ANNOUNCED HIS RETIREMENT AT THE END OF THE YEAR. I KNOW I SPEAK FOR MEMBERS ON BOTH SIDES OF THE AISLE IN SAYING THAT IT'S BEEN A PLEASURE WORKING WITH YOU, AL. THOUGH WE MAY NOT HAVE AGREED ON MANY ISSUES -- IN FACT, WE MAY NOT HAVE AGREED ON <u>ANY</u> ISSUES! -- I HAVE REALLY ENJOYED OUR ASSOCIATION, AND APPRECIATE YOUR FAIRNESS AND WILLINGNESS TO MOVE THE COMMITTEE PROCESS FORWARD. I HOPE THAT WE'LL BE ABLE TO CONTINUE DOING THAT THIS YEAR, AND I WISH YOU A LONG AND HAPPY RETIREMENT.

THIS MORNING, THE SUBCOMMITTEE CONSIDERS THE ADMINISTRATION'S PROPOSAL TO REFORM THE COMMUNITY REINVESTMENT ACT. THIS PROPOSAL WAS PUBLICLY UNVEILED IN DECEMBER, FOLLOWING PRESIDENT CLINTON'S DIRECTIVE LAST YEAR TO OVERHAUL THE REGULATIONS GOVERNING CRA. THE PRESIDENT'S MANDATE WAS SIMPLE, STRAIGHTFORWARD, AND ONE THAT ALL SIDES OF THE ISSUE AGREE WITH: DECREASE PAPERWORK, AND INCREASE PERFORMANCE.

HOWEVER, THIS PROPOSAL ILLUSTRATES ONE OF THE CENTRAL TRUTHS OF WASHINGTON: IT'S EASY TO POINT TO THE END ZONE, IT'S ANOTHER THING TO PUT THE BALL THERE. THE ADMINSTRATION'S CRA PROPOSAL HAS GENERATED INTENSE INTEREST AND SCRUTINY FROM ALL CORNERS, INCLUDING LENDERS, COMMUNITY-BASED ORGANIZATIONS, THE CONGRESS, AND EVEN THE GENERAL ACCOUNTING OFFICE. THAT'S UNDERSTANDABLE, BECAUSE -- EVEN THOUGH CRA HAS GENERATED OVER $30 BILLION IN LOANS TO LOW- AND MODERATE-INCOME COMMUNITIES OVER THE YEARS -- IT'S A LAW THAT HAS BEEN POORLY ENFORCED.

COMPTROLLER LUDWIG AND HIS COLLEAGUES DESERVE CREDIT FOR THE EFFORT THEY HAVE MADE TO SATISFY THE PRESIDENT'S TWIN GOALS OF IMPROVED PERFORMANCE AND REDUCED PAPERWORK. THEY ARE THE REGULATORY EQUIVALENT OF THE "FLYING WALLENDAS", THE LEGENDARY HIGH WIRE PERFORMERS. HERE, THEY ARE CERTAINLY WALKING A TIGHTROPE IN TRYING TO MEET THE PRESIDENT'S GOALS, BECAUSE THE CONSEQUENCES OF FAILURE ARE SEVERE. IF THEY SLIP TO THE SIDE OF REDUCING PAPERWORK, THEY HARM THE GOAL OF INCREASING PERFORMANCE, AND VICE VERSA.

THE PROPOSAL THEY HAVE SUBMITTED FOR PUBLIC COMMENT GETS THEM PART OF THE WAY ACROSS THE WIRE, BUT NOT CLEAR TO THE OTHER SIDE. WHILE IT CONTAINS SEVERAL COMMENDABLE FEATURES, IT ALSO RAISES SERIOUS QUESTIONS THAT MAKE IT UNCERTAIN WHETHER THIS PROPOSAL WILL FULFIL ITS OBJECTIVE. LET'S TAKE A FEW EXAMPLES:

FIRST, THE NEW "INVESTMENT TEST" IS A STEP FORWARD INSOFAR AS IT REWARDS LENDERS -- ESPECIALLY WHOLESALE AND SPECIAL PURPOSE LENDERS -- WHO INVEST IN CDC'S AND OTHER ACTIVITIES THAT BENEFIT LOW- AND MODERATE-INCOME COMMUNITIES. HOWEVER, THIS TEST ALSO ALLOWS A BANK'S OVERALL CRA RATING TO BE INCREASED BY **TWO** LEVELS IF IT MAKES A LOT OF INVESTMENTS. THAT MEANS THAT, IF A BANK DOES A POOR JOB OF LENDING TO LOCAL COMMUNITIES, IT CAN STILL GET AN OUTSTANDING CRA RATING JUST BY WRITING A CHECK. THIS PROVISION MAY CREATE AN INCENTIVE IN LENDERS TO COMPLY WITH CRA NOT BY MAKING NEW LOANS, BUT BY "BUYING" A GOOD RATING. ALTHOUGH I THINK IT'S A GOOD THING TO ENCOURAGE INVESTMENTS, WE SHOULDN'T BE DOING THAT AT THE RISK OF DISCOURAGING LENDING.

SECOND, THE PROPOSAL TO COLLECT DATA FROM LARGER LENDERS ON THEIR BUSINESS LENDING IS ANOTHER STEP IN THE RIGHT DIRECTION. AS WE HAVE SEEN WITH HMDA, LENDING DATA SHEDS IMPORTANT LIGHT ON WHETHER AND HOW A LENDER IS MEETING COMMUNITY CREDIT NEEDS. HOWEVER, THIS PROPOSAL DOES NOT COLLECT DATA ON THE RACE AND ETHNICITY OF BORROWERS. THAT INFORMATION IS ESSENTIAL TO ENSURE THAT BUSINESS LOANS ARE BEING MADE TO COMMUNITY MEMBERS. AS THE PROPOSAL IS CURRENTLY WRITTEN, IT COULD BENEFIT RESIDENTS OF AFFLUENT COMMUNITIES RATHER THAN THOSE OF LOW- AND MODERATE-INCOME AREAS -- WHICH IS WHAT CRA REQUIRES.

THIRD, THE VALUE OF THIS NEW DATA COULD BE UNDERMINED BY ERRORS. A RECENT G.A.O. SURVEY INDICATES THAT AS MUCH AS **30 TO 40** PERCENT OF DATA REPORTED UNDER HMDA IS INACCURATE. DESPITE THIS HUGE ERROR RATE, THOUGH, THE AGENCIES HAVE INDICATED TO THE G.A.O. THAT THEY DO **NOT** PLAN TO VERIFY THE ACCURACY OF THE NEW BUSINESS LENDING DATA THAT WILL BE REQUIRED UNDER THE PROPOSAL. THAT CREATES A HUGE INCENTIVE ON THE PART OF LENDERS TO BE CARELESS, AND IN THE LONG RUN COULD MAKE THIS DATA PRACTICALLY USELESS.

FOURTH, THE ADMINISTRATION PROPOSES LESS STRINGENT REQUIREMENTS FOR LENDERS WITH LESS THAN $250 MILLION IN ASSETS. THESE INSTITUTIONS -- WHICH MAKE UP ABOUT 75% OF THE COUNTRY'S LENDERS -- WOULD BE EXEMPT FROM THE 3 PERFORMANCE-BASED REQUIREMENTS AND THE NEW DATA REPORTING REQUIREMENTS. INSTEAD, THEY WOULD BE PRESUMED TO HAVE A SATISFACTORY RATING IF THEY MET 6 STANDARDS THAT MOST WELL-RUN LENDERS SHOULD MEET ANYWAY. I BELIEVE THAT TOO MANY EXAMINERS HAVE UNFAIRLY ASKED SMALLER LENDERS TO PRODUCE PAPERWORK COMPARABLE TO LARGER LENDERS. THAT PRACTICE SHOULD STOP. HOWEVER, I QUESTION THE WISDOM OF EFFECTIVELY REMOVING A LARGE NUMBER OF LENDERS FROM CLOSE SUPERVISION BY THE AGENCIES. ALL THE EVIDENCE SHOWS THAT SMALLER INSTITUTIONS ARE JUST AS LIKELY -- IF NOT MORE LIKELY -- TO HAVE UNSATISFACTORY CRA RATINGS AS LARGER INSTITUTIONS. THESE INSTITUTIONS NEED MORE APPROPRIATE SUPERVISION, NOT LESS SUPERVISION.

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FIFTH, AND FINALLY, THESE REGULATIONS BEYOND A DOUBT MOVE CRA ENFORCEMENT MORE IN THE DIRECTION OF PERFORMANCE. THAT IS A POSITIVE CHANGE. HOWEVER, THE G.A.O. HAS STATED THAT THE PROPOSED REGULATIONS WILL REQUIRE MORE AND BETTER TRAINED EXAMINERS TO ENFORCE THEM APPROPRIATELY. I AM CONCERNED THAT THE AGENCIES WILL NOT HAVE A CAPABLE FORCE OF EXAMINERS IN PLACE WHEN THESE REGULATIONS HIT THE STREET.

THESE ARE JUST SEVERAL OF THE AREAS THAT I BELIEVE NEED FURTHER CONSIDERATION IF THESE REGULATIONS ARE GOING TO ENSURE THAT CRA IS FINALLY GIVEN THE PRIORITY IT DESERVES. I LOOK FORWARD TO WORKING WITH THE REGULATORS, AND OTHER WITNESSES, WHO ARE WITH US TODAY TO GET THE JOB DONE, AND PUT THE BALL INTO THE END ZONE.

BOBBY L. RUSH
1ST DISTRICT
ILLINOIS

CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

COMMITTEES:
BANKING, FINANCE AND URBAN AFFAIRS
GOVERNMENT OPERATIONS

OPENING STATEMENT FOR CONGRESSMAN BOBBY L. RUSH FOR HOUSE BANKING SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE HEARING ON THE COMMUNITY REINVESTMENT ACT (February 8, 1994)

Thank you. I am pleased that Chairman Kennedy has convened this hearing this morning on the recently-announced Clinton Administration regulatory revisions to the Community Reinvestment Act. As I don't need to tell those in this room, making certain that these revisions are done well is extremely critical: although there were some of us that have worked hard on the Community Development Financial Institutions bill and look forward to the President's signing it into law this Spring, the potential for funding genuine community development that the CRA effort contains almost boggles the mind in comparison to that of CDFI. But first, there are some mine fields to negotiate: as is frequently the case with such complicated policy matters, virtually no one is happy with the regulations as proposed. For example, some community and consumer organizations are concerned that the level of scrutiny that will be afforded to institutions with assets of less than $250 million is not sufficient,

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and many banks feel that the disclosure provisions of the regulations will be overly burdensome. Time will tell. I look forward to working with Chairmen Kennedy and Gonzalez, my House Banking Committee colleagues, the banking industry, and community and consumer representatives to give CRA reform the careful consideration and attention that it is due. Thank you.

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TESTIMONY OF

EUGENE A. LUDWIG
COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

of the

U. S. HOUSE OF REPRESENTATIVES

February 8, 1994

Mr. Chairman, and members of the Subcommittee, I welcome this opportunity to discuss the efforts of the Office of the Comptroller of the Currency--in cooperation with the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System--to change fundamentally how we evaluate the performance of banks and thrifts under the Community Reinvestment Act (CRA).

The CRA reform effort is an important part of the Administration's efforts to promote increased credit availability and economic growth. In the past year, the bank and thrift supervisory agencies have worked diligently to create a regulatory environment in which banks and thrifts can apply their skills and judgment to the task of extending credit to creditworthy borrowers, wherever they may be located. Initiatives taken by the banking agencies--such as the creation of a new low-documentation program for small business loans, the proposal to reconsider appraisal requirements for real estate loans, and the institution of a formal process for appealing examination decisions--have already begun to affect the flow of credit to households and businesses. But we need to take additional steps to ensure that the benefits of greater credit availability are shared by all segments of society. By reforming how we assess bank performance under the CRA, I believe that we can channel billions of dollars of new credit into America's distressed communities.

I want to emphasize that the Administration does not regard the CRA program as a hand-out for distressed communities, and we are not asking banks and thrifts to make bad loans. I have learned in the course of our efforts to reform the CRA that there are numerous opportunities to make good, profitable loans in all parts of the community, including low- and moderate-income areas. One of the most encouraging developments to emerge from the CRA is the involvement of local community organizations in identifying creditworthy borrowers in low- and moderate-income neighborhoods and linking them with sources of credit. Such organizations also play a key role in promoting community development.

Background

The Community Reinvestment Act was enacted in 1977 to prevent redlining and to promote affirmative efforts by banks and thrifts to help meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods. In many respects, the CRA is an extension and clarification of the long-standing expectation that banks will serve the credit needs of their communities. The CRA--and the regulations issued under the CRA--require federal regulators to assess the record of each bank and thrift in helping to meet the credit needs of all portions of its community, including low- and moderate-income neighborhoods, and to take that record into account when considering corporate applications for charters or for approval of mergers, acquisitions, branch openings, or office relocations.

The CRA provides a framework in which depository institutions and community groups can work together to promote the availability of credit and other banking services to underserved communities. Under the impetus of the CRA, many banks and thrifts have

opened new branches, provided expanded services, adopted more flexible loan underwriting standards, and made substantial commitments to state and local governments or community groups to increase lending to all segments of society.

Despite these positive results, the current CRA process lacks credibility with the banking industry and with representatives of the communities that the Act is intended to benefit. Community and other groups complain that many communities are not adequately served because the CRA evaluation process does not focus enough on actual lending, investments, and services provided. At the same time, bankers complain that the current implementation of the CRA results in excessive burden relative to the benefits that the system produces.

It was against this backdrop of broad dissatisfaction with the current approach to CRA that President Clinton, in July of last year, challenged the federal regulators of banks and thrifts to make fundamental changes in the way we administer the CRA. The President established several broad principles to guide the agencies' reform efforts. He called for CRA assessment standards that are based more on measurable performance, less burdensome CRA examinations that are more consistent and even-handed, the elimination of unnecessary documentation requirements, better public access to information on CRA evaluations, and tougher actions against institutions with persistently poor CRA performance.

To ensure that CRA reform addressed the needs of the banking industry, community groups, and other key sectors of the community, the federal banking agencies held a series of seven public hearings last year at locations around the country. These hearings represent the most extensive effort on the part of the agencies to solicit public views on community reinvestment since the CRA was enacted in 1977. The hearings were attended by the heads of the OCC, OTS, and FDIC, and by Federal Reserve Governor Lindsey. This unusually high-level representation at the hearings reflects the great importance that the agencies have accorded this effort. I think I can speak for all four of us when I say that we learned a great deal about the problems facing low- and moderate-income areas, and came away with a unique appreciation for the issues involved in CRA reform.

Following the public hearings, the agency heads and Governor Lindsey worked closely together to come up with the proposal that was announced jointly by the federal banking agencies. The proposal is designed to meet the objectives established by the President. It emphasizes results rather than process, and is intended to ensure that all segments of our society have access to credit and other financial services provided by banks and thrifts.

The agencies published the proposed rule in the Federal Register on December 21st. We still have work to do, however, before we can put a final rule in place. The comment period was originally scheduled to close on February 24th, but because of the considerable public interest in the rule, the significance of the changes we are proposing, and the fact that the proposal was published shortly before the Christmas and New Year holidays, the agencies agreed to extend the deadline for comments by 30 days, to March 24th.

I cannot predict at this point exactly what the provisions of the final rule will be. That will be determined by the rulemaking process, after the agencies have had the opportunity to review all of the public comments we receive. I am committed to accomplishing that as expeditiously as possible, and it is my expectation that we will publish a final rule in the late spring.

The agencies propose that the data collection required by the proposed rule would go into effect on July 1, 1994, with larger institutions having to report data for the last six months of 1994 by January 31, 1995. Evaluations under the new standards would become mandatory after July 1, 1995. Until then, banks would be able choose whether they will be evaluated under the new rule or under the old CRA standards. This proposed schedule assumes, of course, that a final rule is published in the spring. We will modify this schedule if the rulemaking process takes longer to complete.

I must underscore that our efforts will not produce a panacea. Reform of CRA regulations and examination procedures cannot solve all the problems of distressed rural and urban communities, nor answer all the complaints of bankers about regulatory burden. But I am confident that at the end of the process we can have a CRA evaluation system that is far superior to the one we currently use.

Balancing Competing Interests

The proposed rule published on December 21st is the result of five months of consultation and deliberation. The four federal banking agencies held seven public hearings, at which we heard from more than 250 witnesses representing community groups, small businesses, financial institutions, local governments, and other individuals and organizations. Another 50 persons submitted written statements for the record. We also walked through South Central Los Angeles and a predominantly minority neighborhood in New York City to see for ourselves how banks were serving their communities, and to talk with residents. We spoke with representatives of the Navajo nation, with officials from large and small banks, and with poor people in rural North Carolina.

Although those we heard from held diverse viewpoints, there were many areas of agreement. Our efforts focused on building upon those areas of agreement. For example, most of those who commented--bankers, government officials, and leaders of community-based organizations--called for a system that evaluated performance without resorting to a formula-driven approach. They emphasized that CRA evaluations should focus primarily on lending, particularly to low- and moderate income individuals, small farms and businesses, and affordable housing and economic development organizations, but they stressed that an institution's lending record should be viewed in the context of its business strategy, its financial condition, and the credit needs of the community in which it operates. Expressing a closely related point of view, many small institutions noted that the documentation requirements of the current CRA regulation consume resources that could be better used providing credit and services to their communities.

Many commenters expressed interest in enabling financial institutions to work with community representatives to develop strategic plans, with measurable goals, for meeting their CRA obligations. Some wanted the CRA process to center upon enforceable agreements between community groups and financial institutions, while others suggested that the CRA process should center on enforceable agreements between institutions and their regulators.

A number of commenters noted that implementation of a meaningful performance-based evaluation process would require the collection of data on the geographic distribution of small business and consumer loans. Other witnesses, particularly those who represented smaller institutions, noted the regulatory burden that institutions currently bear, and urged that the regulation mandate no additional reporting of loans.

Many financial institutions and some community groups expressed the view that the current system focuses too much on punishing institutions that fail to help meet the needs of their communities. They suggested that the revised regulation should focus more on providing incentives for institutions that meet the credit and service needs of their communities. Outside the banking and thrift industries, however, there was strong opposition to establishing a "safe harbor" from protests based on the regulator's evaluation of an institution's CRA performance.

The agencies tried to address many of these concerns in developing the proposed rule. The proposal would not allocate credit, or require any institution, in any community, to provide any set level of lending, service, or investments to any constituency. Rather, it would base CRA evaluations more on objective measures of a bank's lending, service, and investment activities, while continuing to evaluate each institution's record in light of its business strategy and conditions in its community. It contains no "safe harbor," but provides incentives for strong CRA performance by specifying how the agencies will consider CRA performance when deciding an application, and by establishing that institutions whose performance is in substantial noncompliance with the requirements of the law may be subject to enforcement action.

We believe the proposed rule would make significant reductions in regulatory burden for most institutions. The proposal is longer, in terms of pages of text, than the current CRA regulation, but its overall effect is to simplify the CRA process. The proposal would reduce the number of CRA evaluation factors from 12 to three. Moreover, by replacing subjective factors with measurable, objective standards, the proposal would reduce regulatory uncertainty. Finally, the proposal would tailor CRA requirements to the circumstances of different types of institutions. While this adds to the overall length of the regulation, it means that any given institution would have to deal only with those sections of the regulation that would apply to it.

The proposal would require data reporting on loans to small businesses and consumers, but smaller institutions could choose to be evaluated under streamlined procedures that would not require them to make these reports. Furthermore, the proposal would eliminate the need for banks and thrifts to prepare detailed CRA statements, to review those statements annually

and note those reviews in the minutes of board meetings, to justify the basis for their community delineations, to explain the methods they used to ascertain community credit needs, or to maintain voluminous files documenting their marketing efforts in low- and moderate-income areas. The resources formerly devoted to such procedural requirements would be available for strengthening capital and making new loans.

I do not mean to suggest that the proposal would impose no regulatory burden. The agencies need some information on banks' and thrifts' lending, community investments, and other services provided to low- and moderate-income areas in order to refocus CRA evaluations on objective measures of performance. As a result, some institutions would not see as great a reduction in regulatory burden as others. The regulatory burdens they did bear, however, would be more directly linked to the provision of banking services to their communities. The unproductive burden associated with the current process--which bases CRA evaluations largely on documentation--would be eliminated.

Principal Features of the Proposed System

Performance-based evaluations. The regulatory agencies propose to replace the twelve assessment factors currently used to evaluate compliance with the CRA with a performance-based evaluation system. The current assessment factors are almost entirely subjective, and unduly burdensome. Under the proposed system, depository institutions would be assessed on results, measured in objective terms: the loans they provide, the investments they make, and the services they offer in their communities.

Flexibility. The agencies have not proposed to require any set level of lending to any particular community or constituency. The agencies wish to avoid a formulaic approach to CRA reform, which could have the effect of forcing institutions into a common mold. Where the proposal does use specific tests or benchmarks, they take the form of rebuttable presumptions that would permit each institution to be evaluated on the basis of it own situation.

The proposal is designed to recognize the diversity that characterizes the banking and thrift sectors. In general, institutions would be evaluated on the basis of the product lines they offer to their customers in the normal course of business, so in no way would the proposed regulation require banks and thrifts to offer specific products or to make loans or investments that are inconsistent with safety and soundness.

Lending Test. The agencies propose to evaluate retail institutions primarily on the basis of the loans they make. The evaluation would be based on objective measures of the institution's activities: the number, dollar volume, and geographic distribution of its loans. The agencies would use this information to apply a lending test, which institutions could rebut where circumstances warranted. Lenders would receive extra credit for making complex or innovative loans or loans that serve particularly pressing community needs.

The lending test would include two main components. The first component would, in effect, evaluate an institution's lending record in low- and moderate-income areas against the lending records of its competitors. It would do so by comparing the institution's market share of reportable loans in low- and moderate-income areas within its service area with its share of such loans in the rest of its service area. (Reportable loans would include home mortgage, consumer, small business, and small farm loans.)

The second component of the lending test would evaluate the institution's record in isolation, by comparing the volume and number of reportable loans that a bank or thrift made in low- and moderate-income areas in its service area with the volume and number of such loans that it made throughout its service area, or, alternatively, by examining the geographic distribution of such loans across the low- and moderate-income areas in the institution's service area.

By looking at both components, the agencies hope to ensure that favorable ratings under the lending test would reflect a reasonable distribution of loans among low-, moderate-, and high-income neighborhoods in the bank's service area, while at the same time avoiding the possibility of unfairly penalizing a bank that--despite strong efforts in low- and moderate-income neighborhoods--had a relatively small market share simply because it had more competitors there than elsewhere in its service area. And I would like to emphasize again that the results of the lending test--like the other tests contained in the proposal--could be rebutted where circumstances warranted. For example, a bank that did not make as many loans in low- and moderate-income areas as its competitors did might still pass the lending test if its lending record compared favorably with other institutions on a regional or national basis.

The agencies propose to credit to a bank or thrift institution--at its option--its share of the loans made by non-bank entities in which the bank or thrift has invested or participated. Such entities could include consortia of banks or thrifts, community development enterprises of various kinds, or other organizations that make loans in the bank's or thrift's service area. The fraction of the entity's loans for which a given bank or thrift received credit would usually be equal to the bank's or thrift's share of the entity's overall funding.

Investment Test. The agencies propose to evaluate wholesale and limited-purpose institutions--defined as institutions without a significant volume of home mortgage loans, consumer loans, or loans to small businesses and small farms--primarily on the basis of investments they make that benefit low- and moderate-income neighborhoods or individuals within the institution's service area. The agencies would base their evaluation of an institution's investment performance on the amount of assets--relative to the institution's risk-based capital--that it devoted to qualifying investments. Qualifying investments would include investments in organizations, consortia, and initiatives that foster community lending, community development, or affordable housing; and investments in state and local government agency housing or revenue bonds that are specifically aimed at helping low- and moderate-income communities and individuals.

The focus of the investment test would be the effect of the investments on the community rather than the investment *per se*. Investments would not be credited under the test unless they had a demonstrable impact on the provision of credit, community development projects, or services benefiting low- and moderate-income individuals or areas. Regulators could adjust an institution's rating under the investment test to take into account investments that are particularly innovative or that meet special needs. If an institution made an investment that indirectly generated lending, the institution could receive credit for the indirect lending under the lending test, and credit for the rest of the investment under the investment test.

Retail institutions would also be evaluated on the basis of their investment performance. Those whose investment performance was found to be outstanding would have their "base" CRA rating, reflecting their performance under the lending test, raised by two levels on the five-level scale. Those whose investment performance was the higher of the two satisfactory ratings would have their base CRA rating raised by one level. The absence of investments, however, would not penalize an institution. Although we believe that suitable investments can complement an institution's lending record, the CRA does not obligate banks and thrifts to make community development investments.

Service Test. The agencies propose to evaluate all institutions on the basis of the services they provide in low- and moderate-income neighborhoods. Evaluations of retail institutions would focus on the accessibility of branches, while the evaluation of wholesale and limited-purpose institutions would focus on their support for services that promote credit availability in low- and moderate-income areas, such as credit counseling, low-cost or "lifeline" checking accounts, financial planning, home ownership counseling, and loan packaging that assists small and minority businesses. An institution's performance under the service test could boost its overall CRA rating in the case of outstanding service, and reduce its rating in the case of substantial noncompliance in service.

The proposed evaluation system has been designed so that an institution's CRA rating would reflect its performance in all the communities in which it operates. For banks and thrifts that do business in more than one community, the agencies propose to evaluate all of the institution's loan data, and to conduct full lending and service tests in a sample of its service areas. The agencies would then assign separate composite CRA ratings for each area, with the bank's or thrift's overall rating reflecting its performance in all areas studied.

In the view of the agencies, a financial institution is not serving its entire community if it is discriminating illegally. The proposal would therefore establish a rebuttable presumption that an institution would receive a composite rating of less than satisfactory if the institution had committed an *isolated act* of illegal discrimination of which it had knowledge, and that it had not corrected or was not in the process of correcting; or if it had engaged in a *pattern or practice* of illegal discrimination that it had not corrected. That presumption could be rebutted in the case of technical or *de minimis* violations.

<u>Data on lending patterns</u>. The agencies propose to require all banks and thrifts (except those that use the streamlined assessment method described below) to collect and report to their supervisor data on the geographic distribution of their home mortgage, consumer, small business, and small farm loans. This would be in addition to data already collected under the Home Mortgage Disclosure Act (HMDA) and the agencies' fair housing data collection requirements. The reports would include data on written applications received by the institution, denials of applications, loan originations, and loan purchases. These data would form the basis of the agencies' evaluations under the lending test, and would be made available to the public by the individual lenders and the agencies. The Federal Reserve Board would continue to make available to the public the information that institutions collect under HMDA.

<u>Alternative assessment method for smaller banks and thrifts</u>. In the course of the public hearings that preceded the development of the proposal, representatives of many small institutions urged the regulators to exempt small banks and thrifts from CRA assessments. The agencies have not proposed to do so because such an exemption could result in the neglect of the credit needs of communities served by smaller banks and thrifts, and because we do not believe that such an exemption is permitted by the statute. The agencies are proposing, however, to use their discretion under the CRA to offer small banks and thrifts--defined as independent banks and thrifts with total assets of under $250 million, or members of a holding company with total banking and thrift assets of less than $250 million--the option of a streamlined assessment method. Smaller institutions that chose to be assessed under the streamlined method would not have to comply with the proposed data collection requirements necessary to apply the general assessment method.

The proposed streamlined process is designed to measure how well smaller banks and thrifts are serving the needs of their entire local communities. The primary basis for a small institution's rating would be an evaluation of its lending record. As a general rule, an institution would receive a satisfactory or better CRA rating if it had a reasonable loan-to-deposit ratio; made most of its loans locally; made a variety of loans across income levels; and did not have any bona-fide community complaints or fair lending violations.

In addition, at the option of the institution, the regulator would evaluate the institution's record of making investments that result in the provision of credit and financial services to low- and moderate income areas within their communities, and its record of providing branches, remote service facilities, automated teller machines, and other services that enhance credit availability or otherwise meet the needs of low- and moderate-income persons in its service area. Strong performance in these areas could raise an institution's rating from satisfactory to outstanding.

The regulator would also seek the views of community members, particularly when there are complaints about the institution; and review the findings of the institution's most recent fair lending examination. In the event that a small institution failed to meet or exceed the standards for a satisfactory rating, its regulator would conduct a more extensive examination of its loan-to-deposit ratio, its record of lending to its local community, and its loan mix.

In order to make it easier for small institutions to use these streamlined procedures, the agencies propose that a loan-to-deposit ratio of 60 percent or more would be presumed to satisfy the test for a reasonable loan-to-deposit ratio. The 60 percent ratio would not be a requirement or a bright-line test that an institution would either pass or fail. Rather, it is intended as a helpful presumption that would provide a simplified method for demonstrating compliance for the roughly half of community banks whose ratio exceeds 60 percent. The underlying requirement would be the same for all institutions using the streamlined procedures: those above and below the 60 percent figure. They would have to have a reasonable loan-to-deposit ratio given their size, their financial condition, and the credit needs of their communities. An institution in a community where there is insufficient loan demand to reach a 60 percent ratio would need only to have a ratio that is reasonable given the level of demand.

Strategic plan alternative. Under the proposed rule, any institution, rather than being assessed under the lending, investment, and services tests, could submit for agency approval a plan with measurable goals against which the agency would assess the institution's subsequent CRA performance. The proposal would not specifically require institutions to involve community groups and other members of the public in the formulation of their strategic plans, but we would certainly encourage them to do so. An institution would be required to disclose its plan publicly before it is evaluated by its regulator, and the regulator would consider public comments in its assessment of a submitted plan.

If the agency approved the plan, it would base its subsequent CRA reviews of that institution on whether it met or exceeded the goals specified in the plan. If the institution failed to meet the preponderance of the measurable goals set forth in the plan, its performance would be evaluated under the lending, service, and investment tests (or, for eligible institutions, the small bank assessment method). Assessment under an approved plan would not relieve an institution from its obligation to report data on the geographic distribution of loans.

Examination and enforcement. The federal regulators of banks and thrifts would continue to consider CRA performance in evaluating applications to charter a bank or thrift, to obtain deposit insurance, to establish or relocate a branch office or ATM, or to acquire another insured depository institution or its assets. Under the proposal, as today, the CRA examination rating would often be the most important factor in assessing CRA performance, but it would not be the exclusive consideration, and could be overridden by other factors, such as information collected through public comment, legitimate complaints, and fair lending violations.

Under the proposal, a rating of "outstanding" would generally be consistent with approval of the application, and would receive extra weight in reviewing the application. A rating of "satisfactory" would also be consistent with approval, but it would not receive extra weight. A rating of "needs to improve" would generally be an adverse factor in the CRA review of the application, and in the absence of demonstrated improvement in the bank's CRA

performance or other countervailing factors would generally result in conditional approval or denial of the application. A rating of "substantial noncompliance" would generally result in denial of the application.

The agencies recognize, however, that the corporate application process alone is not sufficient to ensure effective enforcement action against institutions that fail to satisfy their CRA responsibilities. It is only effective for institutions that face branch opening or relocation decisions or that are active in mergers and acquisitions. The agencies therefore propose that an institution that received a composite rating of "substantial noncompliance" would be subject to formal and informal enforcement measures authorized by 12. U.S.C. 1818.

In addition to considering CRA performance in the application process and exercising their general enforcement powers, the agencies plan to use the frequency of CRA examinations to provide incentives for strong performance. Institutions with ratings of "outstanding" will generally be examined less frequently than the average institution, while institutions with less than satisfactory ratings will generally be examined more frequently. Of course, other factors, such as an institution's financial condition, will also affect the frequency of examinations, and in no case do we plan to examine banks less frequently than once every two years. The agencies believe that linking examination frequency to performance makes sense not only because it provides an incentive for strong performance, but also because it reflects a sensible allocation of the agencies' limited examination resources.

Appeals. The subcommittee's letter of invitation inquired about the process that depository institutions will be able to use to appeal their CRA ratings. Disagreements between bankers and bank examiners are a normal part cf the supervisory process. In most cases, such disagreements can be resolved through informal discussions. When they cannot, however, banks have a right to a fair prompt review of the disagreement.

On March 10th of last year, the federal banking agencies announced that they would be overhauling their appeals processes to ensure that appeals are handled fairly and expeditiously, and do not result in retribution against either the bank or the examiner. The OCC's new review process for banker appeals, which the agency announced on June 10, encourages bankers to seek a review of any disputed examination decision, establishes specific time limits for action on appeals, and creates a new Ombudsman position to oversee those reviews.

Under the new process, national banks may appeal any examination findings to the Ombudsman, including CRA ratings and other results of CRA examinations. (The only exception to this rule is for a limited set of matters where the appeal could adversely affect safety and soundness, such as the appointment of receivers and conservators; preliminary examination conclusions communicated to the national bank prior to the issuance of written communication from the OCC, such as a final Report of Examination; and enforcement-related matters.) Since these new appeal procedures apply to CRA appeals, the banking agencies did not see any need to include separate appeal procedures in the proposed CRA rule.

Conclusions

The Administration's CRA proposal attempts to strike a reasonable balance between improving the availability of banking services in underserved urban and rural communities, and minimizing regulatory burdens on the banking industry. Consequently, both community groups and bankers may not be completely satisfied with some provisions of the proposed rule. Bankers need to recognize that it is worth making an effort to bring currently underserved areas into the mainstream of financial markets. Community groups need to recognize that even well-intentioned requirements, if they are too burdensome, can weaken the banking industry and reduce its capacity to serve the banking public--including low- and moderate-income neighborhoods. I would ask both groups to compare the agencies' proposal with the status quo, and ask, first, whether it represents an overall improvement over the status quo, and second, what changes are needed to make the proposal more effective. I look forward to hearing their comments.

NEWS RELEASE

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Remarks by
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Comptroller of the Currency

Before the
National Community Reinvestment Coalition

Washington, D.C
February 7, 1994

INTRODUCTION

Thank you and good afternoon.

I see a lot of familiar faces here, and for a very good reason: your singular involvement in Community Reinvestment Act reform. Irvin Henderson was at the White House when President Clinton announced the goals of the reform process. You had representatives at each of the hearings that have shaped reform so far. In fact, at one of those hearings Irvin Henderson originated the idea of "capture ratios," which would later appear as the market share screen in the Administration's CRA proposal. You were there every step of the way. As we go forward I am certain that your thoughts and your words will be as important in shaping the outcome of CRA reform as they were in contributing to the form and substance of the Administration's proposal.

To me, community reinvestment is not some vague abstraction. I know, not by analysis but by personal example, how important credit can be in the life of the individual and the community.

My father was the son of an immigrant and a son of the Great Depression. He wanted something better for his family than the hard times he had known growing up. He wanted to go to medical school and to practice medicine as a country doctor. A bank made his dream possible by providing him with the credit he needed to get his start in life. Not only did he and his family benefit from this credit, so too did the community of York, Pennsylvania, where he practiced. He devoted 60 years of service to that community, through the free medical clinic he ran once a week and in many other ways.

My father had a dream -- an American dream of taking charge of his life, and through hard work and individual responsibility, making both a success of himself and a contribution to a better society.

Millions of Americans today have the same dream -- Americans from both sides of the tracks. For many -- perhaps most -- people in our capitalist society, access to credit is the key to achieving this dream. A person's ability to go to school, to buy a house, to start a business, is often determined by whether credit is available. Further, by enabling borrowers to become producers, credit can be the means through which people in a capitalist system escape poverty. Put simply: Credit is often the hammer that allows people to forge their future.

Credit is critical to the workings of the capitalist economy. And credit allows people outside the mainstream of that economy to enter it. For all of these reasons, fair and equal access to credit is in the public interest.

THE ADMINISTRATION'S PROGRAM

President Clinton understands how important credit is to the well-being and the advancement of all Americans. And he understands how necessary credit is to revitalizing our cities and poor rural areas. He recognizes that we have to encourage genuine economic development if we are to solve the problems of unemployment, poverty and crime. Within days of his coming to office, we began working together on a Presidential credit availability effort that would remove regulatory obstacles to bank lending. And within days of my arrival at the OCC, we launched an aggressive effort on fair lending, an effort to make equal credit opportunity a feature of American banking as unexceptional as the checkbook or the vault.

Further, over the last year, the President has launched an ambitious array of policy initiatives through which Washington will work in tandem with state and local governments, banks and other businesses, community organizations, and other institutions to address our problems. In these initiatives, the federal government acts as a catalyst that brings about desired change. And these initiatives often seek to empower communities to solve their problems themselves. Much work remains to be done here, but we are on our way.

Three of these initiatives directly promote economic growth and development in neighborhoods, communities, and other localities where financial stimulus is needed.

One, as you know the budget bill enacted last August offers tax incentives to businesses that locate within the nine "empowerment zones" and 95 "enterprise communities" the bill authorized. Localities can apply for designation as an empowerment zone or an enterprise community. Two, legislation to fund Community Development Financial Institutions has passed both the full House and the Senate Banking Committee. And, three, Federal bank regulators have proposed a major reform of the Community Reinvestment Act regulation, under which banks must address community credit needs.

These three initiatives are interrelated -- and mutually supportive. They are all three ways of getting the private sector involved in addressing economic needs.

Banks, for example, could meet part of their obligations under the CRA by investing in CDFIs. And CDFIs could interact with banks by exploring new markets that banks could help serve.

THE COMMUNITY REINVESTMENT ACT

The effort to reform the CRA has been a daily concern of mine for more than six months. The proposed rule is intended to fulfill a directive from President Clinton to breathe new life and new purpose into the CRA. Fifteen years ago, Congress passed the CRA to ensure that banks and thrifts served the financial needs of their entire communities, and, in particular, to help economically empower persons of low and moderate income. For a number of reasons, however, the CRA never achieved the full promise Congress had intended.

During the 1992 Presidential campaign, Governor Clinton, responding to the strong complaints of bankers and community leaders, vowed to reform CRA regulations to make the law work. Following up on his campaign pledge, President Clinton last July told us to rethink the entire system of regulation through which we put the CRA into effect. In December, we proposed our reform package.

We crafted the reform package to achieve the goals the President established for us.

Speaking on behalf of my regulatory colleagues -- as well as for myself -- we are eager for the public to comment on the package. We are roughly half of the way through the 90-day comment period, so there is plenty of time left to do so. We want to hear if we have gotten things wrong, if we could do a better job. But we also want to hear if we have gotten things right. We will need positive reinforcement, as well as constructive criticism, when we craft the final package of reforms.

As you know, from the very beginning, we have been dedicated to a painstaking process of consultation and deliberation so the final product would be right. The President gave us a difficult mission. We knew from the start that we could not perform it in a vacuum. Before we made a single decision on proposing reform, we turned to the public for direction. We held a series of hearings throughout the country -- hearings in Washington, Los Angeles, Albuquerque, San Antonio, Chicago, New York City, and Henderson, North Carolina -- the most extensive series of hearings ever held on CRA. We heard more than

250 witnesses and recorded thousands of pages of testimony. We walked through South Central Los Angeles and a minority neighborhood in New York to see with our own eyes and to listen with our own ears to what should be done. We talked with representatives of the Navajo Nation -- to bankers large and small -- to poor people in rural America. What we saw and what we heard shaped the reform package we proposed.

Here in Washington, we heard the Reverend Charles Cummings, Junior, tell us: "Low-income and minority communities here in D.C. are ravaged by a shortage of jobs and of affordable housing. Bank redlining has contributed to the spiral of decline in our communities. Abandoned houses, check-cashing outlets, vacant lots and boarded-up store fronts are the symptoms of a credit famine in our neighborhoods. Community reinvestment is not the only solution to our urban problems, but without bank participation, any plan to turn things around is doomed to fail."

At the same hearing, we heard a banker describe how the current system undercut lenders that were dedicated to achieving meaningful community reinvestment.

"I would like to show you a photo," she said, "and believe it or not it's real, it's not a staged picture. The printouts here make up a pile about 20 feet high and represent the quarterly reports documenting just one aspect of our CRA efforts. Think of the people and the resources that it takes to produce those reports. Would any of you sitting here today wade through that stack of paper in order to make a decision? I don't think so. And our managers, who must balance the need to make community development loans with all of their other responsibilities, feel exactly the same way."

In Arizona, Richard Mike, a small businessman who is a member of the Navajo Nation, testified to his frustration in obtaining bank credit to expand his operations on the reservation. He was told that a government agency guarantee would be required for such a loan. Mr. Mike stated: "If the Navajo Nation and its people are to become financially independent, it is essential that they have access to credit and banking services. I believe the U.S. insured banks in Arizona have a long way to go to meet the requirements of the Community Reinvestment Act when an established businessman from the Navajo Nation is willing to offer a high equity loan, full personal guarantees, waiver of sovereign immunity by the Navajo Nation, liens on all other assets and properties, and still be unable with a good business record, a good location, and a good financial position, to secure any loan without a government guarantee."

I would also like to briefly mention what Angela Roberts told us. Ms. Roberts works with the BEC New Community Shepherds Program, an organization in Brooklyn, New York, that provides counseling to credit applicants.

Ms. Roberts said: "There is no great mystery about the reasons our cities and rural areas are in trouble. Reinvestment is the key. Recycle our capital in part back into our communities so that we can build housing and small businesses and we will see the end of guns and drugs and an enormous decline to crime. Do that and we will see a new American renaissance."

If that sounds moving coming from me, imagine how moving it was listening to her.

We regulators had a big job to do.

In setting the goals of reform last July, the President could not have been clearer. The implementation of CRA, he said, "has focused too much on documentation and process, and not enough on actual performance. Banks complain about excessive paperwork and inconsistent implementation of the law. Community groups complain that their communities remain unserved, and the CRA evaluations often fail to reflect actual community reinvestment activities."

We were challenged to revise our regulatory approach to reduce unnecessary compliance burdens and to reward improved performance by lenders.

We were challenged to recognize the diversity of lenders -- in size, in the product lines lenders offer -- and the diversity of the markets that lenders serve. Our regulations were to be made flexible to address that diversity.

We were challenged to strengthen enforcement of CRA, particularly in regard to lenders with consistently poor performance.

In our reform package, we have tried to meet all of those goals.

To provide clearer guidance to lenders, the reform package would eliminates the 12 qualitative assessment factors that appear in current regulation. It would eliminate subjective evaluations of minutes, meetings, marketing efforts, and so forth. The proposed rule would make significant reductions in regulatory burden.

No longer would lenders have to prepare CRA statements, review these statements annually and note those reviews in the minutes of the board of directors meetings, or justify the basis for their community delineations, or ascertain community credit needs and explain their methods of doing so.

Instead of public relations or documentation, the proposal would stress quantitative measures of performance: lending, service and investment performance -- the kind of performance you can bank on. No longer would a lender get an "A" just for effort. Under the proposed rule, not every institution would be subject to assessment in each measure of performance. Rather, the regulator would consider the products and services an institution offers in its normal course of business. Retail banks -- those that focus on individual consumers -- would be evaluated primarily on their lending performance. Wholesale banks -- those that focus on serving business -- and limited purpose banks that do not engage in significant retail lending would be evaluated primarily on their investments. In this way, the proposal would respond to the diversity of markets that banks serve. The proposal would also respond to the range in bank size. It would provide for streamlined -- but rigorous -- examinations of small institutions, while stressing that these institutions would still be responsible for helping to meet the credit needs of their entire communities.

Under the proposal, the regulators would publish a list of the institutions that are scheduled to undergo examinations and the public would be invited to submit comments on the CRA performance of any institution on the list.

The proposed regulation would make clear that a lender found in substantial noncompliance with the law would be subject to formal enforcement actions.

And we would work together to improve public access to data required by the Home Mortgage Disclosure Act and the proposed CRA regulations.

CONCLUSION

In the specific ways I have discussed the proposal would meet the goals the President set -- and would address the concerns and needs that we heard expressed in our public hearings.

Let there be no mistake, this is an aggressive proposal. It responds to long and loud criticism of CRA: Bankers, community activists, academic experts, members of Congress and others identifying flaws in our current CRA approach and advocating change.

The proposal would restructure the system of evaluation under CRA -- because virtually everyone agrees that a restructuring is needed. The proposal would judge lenders by what they do, not by what they say -- because virtually everyone agrees that this shift in emphasis is needed. Our proposal would allow differing lenders to meet their CRA obligations in differing ways -- because virtually everyone agrees that this flexibility is needed. This proposal is aggressive -- an aggressive effort to cure the problems in the current system.

Is the proposal perfect? If it were, we would not have had to put it out for comment. Public comment is -- and is intended to be -- a stress test that will reveal flaws and imperfections.

One problem has already come to light: We were not sufficiently clear in communicating several elements of the proposal and as a result there has been some confusion. I would like to address those elements briefly to clear up that confusion.

First of all, there is a misconception that small banks are exempted from CRA. That is certainly not the case. Under the proposal, small banks would be subject to a different kind of examination from large banks -- one that takes into account the differences in the way small banks operate and the size of their portfolios. But we would continue to examine small banks and hold them accountable for meeting all their CRA obligations.

Second, some people have expressed concerns about the 60 percent loan-to-deposit ratio that would be applied to small banks. They have assumed that, if a small bank did not have 60 percent loans-to-deposits, it would automatically receive a less than satisfactory CRA rating. That is not true.

The 60 percent ratio is a screen -- not a test -- one of five screens for small banks in the proposal. If a bank is picked up by this screen, it simply means that examiners will take a closer look at the bank's loans in its local community. There may be good reasons for the lower ratio. For example, it is certainly understandable that a local recession might translate into all banks in a community dropping below a 60 percent loan-to-deposit ratio. If that is the case, the banks' lending may well be satisfactory.

Incidentally, some people have asked the source of that 60 percent ratio. It is nothing more than the median loan-to-deposit ratio for all banks with less than $250 million in assets. That means that at least half of all small banks will pass this screen -- though passing this screen will not alone ensure a satisfactory rating. I hope we will get comments on whether that is the correct ratio or whether we should adopt a more appropriate standard.

Third, there has been some confusion about the market share provisions -- the outgrowth of Mr. Henderson's capture ratios -- in the proposed rule. Again, let me emphasize that this is a screen -- not a test. If a bank does not make it through the screen, that does not mean it will automatically receive a poor CRA rating. This screen tells our examiners the institution needs a closer look -- that where there may be a problem.

A final point of confusion is the notion that the proposal would create a self-contained, stand-alone compliance system -- that once the final rule is in place, nothing more will need to be done. Not true. After the rule is in place we will need to write detailed examination procedures and develop examiner training to ensure consistent application of CRA requirements. We will need to address managerial and day-to-day problems. We will need to establish procedures to govern a range of activities from approving CRA plans to collecting and analyzing data. And we will.

Public comments are an essential part of rulemaking. Already, comments on our propose CRA rule have highlighted points that need clarification or a second look. As we go forward, the regulators will continue to listen to the voice of the public, and respond to it. In doing so, we will assure that CRA reform will address the flaws of the current system, that CRA reform will establish a reasonable and productive process that will endure for many years to come, and that CRA reform contributes significantly to the efforts of the Clinton Administration to increase economic opportunity for everyone in our nation.

Thank you.

For release on delivery
10:00 a.m., EST
February 8, 1994

Statement by

Lawrence B. Lindsey

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Credit and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

February 8, 1994

Mr. Chairman, I appreciate the opportunity to appear before this subcommittee to discuss Community Reinvestment Act (CRA) reform. The Community Reinvestment Act is intended to ensure thet every community has access to adequate credit to help meet its needs. We at the Federal Reserve Board believe that the law has produced substantial benefits. However, the CRA has not -- nor should it be expected to have -- cured all the problems that plague our cities.

As you know, the federal financial institution regulatory agencies are actively engaged in an effort to reform CRA by amending our regulations. This effort is the result of the President's request to make CRA more objective, the ratings more uniform and the paperwork less burdensome. This effort is a challenging one; it involves a substantial commitment by the agencies and encompasses many difficult issues. We are very conscious of the fact that what we do could significantly affect financial institutions and the public alike and that care must be exercised when undertaking such an important project. As we are midway in the process and still receiving comments from the public, our report to you necessarily will be somewhat preliminary.

History of CRA and the Current Reform Effort

Before discussing the proposal to reform CRA, I'd like to briefly review the law and a little of its history, since that history is very relevant to the reform project. The Community

Reinvestment Act calls for the financial regulatory agencies to use their examination authority to encourage institutions to help meet the credit needs of their communities, including low- and moderate-income areas, consistent with safe and sound business practices. The agencies are required to assess the community lending records of the institutions they supervise as part of their examinations and to take into account those records in considering applications. The law, however, gives no other indication how the agencies are to accomplish these tasks, and does not define key concepts, such as how an institution's community is defined or what constitutes satisfactory performance. A considerable responsibility, therefore, was placed by Congress on the agencies.

The regulations adopted in 1978 by the financial regulatory agencies focused, at least in part, on factors related to the process used by institutions to determine the credit needs of their community and how they responded to those needs. To avoid credit allocation, and to allow for the maximum amount of creativity by institutions in meeting the varying credit needs of their localities, these regulations did not attempt to prescribe any particular level of lending. Instead, the evaluation of a financial institution's performance has been based on the application of twelve assesement factors, including how community credit needs are ascertained, the geographic distribution of loans, the record of opening and closing branches and providing services, participation in local community development projects,

and the financial and legal capability of the institution. In determining how well an institution ascertains tha credit needs of its community, examiners have taken into account such matters as the institution's community outreach and credit marketing.

In the course of our review of CRA, we have heard from many consumer and community groups about how valuable the law has been in getting credit extended in low- and moderate-income areas. Some groupe put the success of CRA at $30 billion, which they estimate to be the level of CRA commitments for new credit. I suspect the total impact of CRA considerably exceeds the $30 billion estimate. And, to date, this has occurred with a comparatively light hand from Washington. Indeed, one of the strengthe of the present system is that it allows great flexibility in fashioning programs to meet the different and changing credit needs of this country's diverse communities.

Despite the significant benefits that communities have seen from CRA, the approach taken in the regulations, and the agencies' implementation of that approach, has generated a good deal of criticism. Financial institutions have frequently complained that they are burdened from imprecise rules and inconsistent evaluations on the one hand, and overly prescriptive documentation requirements on the other hand. Small institutions, in particular, complain about the costs of compliance and contend the law is unnecessary because they must serve their entire community to succeed. Further, it appears to some that there is little incentive for institutions to try to

achieve an outstanding rating, especially when applications filed by institutions with outstanding CRA ratings may still be protested by the public.

Community representatives have complained that the regulators emphasize documentation of CRA activities in their examinations of financial institutions, instead of actually measuring the degree to which they are meeting community credit needs. They point to the fact that almost 90 percent of institutions receive "passing" ratings, and the fact that the agencies rarely deny applications for CRA reasons alone, as evidence that regulatory enforcement of the law has been weak. They also wish to have a more formal role in the evaluation process.

While we have tried to respond to these various concerns through modifying our process and providing official guidance, it has become clear that CRA enforcement needs a broad-based review to see whether improvements are in order and if so, what they should be. Consequently, the President requested the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision to reexamine the regulations. The President asked the agencies to improve them by addressing several areas of concern. The objectives outlined by the President, which we also believe are important to the ultimate reform of CRA, include:

- replacing paperwork and process-related requirements with clear objective criteria that measure actual performance; and
- working together to improve uniformity in evaluations and instituting more effective sanctions for consistently poor CRA performance.

The ultimate goal, according to the President's request, is to "replace paperwork and uncertainty with greater performance, clarity and objectivity." We are in full accord with this objective.

The agencies held a series of seven public hearings throughout the country to gather information on tha best way to amend our CRA regulations and enhance our enforcement. Over 250 witnesses testified, many raising common concerns. We were strongly encouraged to revise our regulations so that CRA performance would be evaluated in as objective a manner as possible and to give better guidance on how different types and levels of performance will be rated.

While witnesses stressed that CRA should continue to focus on lending, many also recommended that greater weight be given to investments (such as in community development projects) and the provision of banking services (such as through locating branches and providing low-cost accounts or noncustomer check cashing). Many witnesses requested that institutions be required to collect more data on the geographic distribution of loans in

order that they may be better able to evaluate an institution's CRA performance.

Representatives of smaller institutions, on the other hand, generally criticized the burden and expense they bear from existing documentation requirements. Other witnesses recommended that institutions be allowed to develop their own CRA plans against which their performance would be rated, with these plans reviewed by the agencies. Finally, most witnesses, other than those from financial institutions, opposed providing a safe harbor from CRA protests to institutions rated satisfactory or outstanding.

Following these meetings, we developed the proposed changes to our CRA regulations in conjunction with the other agencies and published them on December 21, 1993. Comment on the proposal has been requested by March 24. We have extended our comment period to that date to accommodate the numerous requests for time to do a complete analysis of what is a very complex proposal. We do not know how many comments will ultimately be received and whether fundamental changes in our proposed approach will be called for. Although I cannot state when a final rule will be adopted, we do intand to move the process along as quickly as is appropriate. And, I want to emphasize that I would not expect any final rule to become mandatory until after an adequate lead tima -- particularly if the proposed data collection requirements, or something similar, are retained.

Most important, I am committed to making sure that our final rule will work. We will do no one any favors by promulgating a rule that is operationally untenable. During this comment period, I am paying particular attention to questions or complaints about the details of implementation and of unintended consequences from how the proposal will work in practice.

Balancing Competing Objectives

With this proposal, we have attempted to achieve the difficult and important goal of balancing the competing concerns of providing greater specificity on what is expected on the one hand without dictating credit decisions on tha other. The proposal attempts to clarify our expectations for CRA performance by (1) creating a new, more numerically driven system for assessing CRA performance in three critical elements: first and foremost, lending, and secondarily, services and investments; (2) requiring the collection of data on the number, amount, and geographic location of small business, small farm, and some consumer loans to use in the assesements; (3) providing for streamlined review of small institutions; (4) permitting institutions to submit their CRA plan in advance to their regulator for approval and public comment as an alternative to being evaluated under the general assessment scheme; and (5) specifying the regulatory sanctions that are possible from noncompliance with the regulations.

In part, tha balance we seek to achieve in the proposal is intended to respond to those most concerned by CRA -- banks and representatives of communities. Despite their different perspectives on CRA reform, I think that in many respects the interests of banks and community representatives are consistent rather than at odds. Both want local lending institutions to be strong and viable so that they will have the capacity to effectively serve their communities over the long term. Both want to assure that the projects that are funded make economic sense for lander and borrower alike. Both also have a common interest in a CRA evaluation system that is fair and consistent, and that avoids unnecessary paperwork. To be sure, community groups may favor more data collection, greater public participation and more stringent accountability than lenders, but on balance, I believe there is greater commonality of interest among the groups in the goals of reform than is often assumed.

Having said that, however, I am sure there are some specific points in the proposal where views may differ -- for example, on the appropriate cut-off level for the more streamlined review procedures for "small banks." Points of difference like this seem unavoidable in a proposal as comprehensive and complicated as ours and the public comment should help us resolve some of the disagreements about the right approach. I can assure you that we have struggled throughout this process to achieve an appropriate balance to the competing

interests where it does exist; how well we have done this will be judged in the public comment process.

Issues Raised by the Proposal

Given Comptroller Ludwig's description of the proposal for the subcommittee, I will not also review the details. As is well known, however, although the Board joined with the other agencies in seeking public comment on the proposal, Board members have a variety of concerns about the proposal. For example:

- The proposal is intended to provide greater certainty to institutions in the type of evaluation they might expect to receive, primarily based on their performance relative to others. Yet, measuring an institution's performance against other lenders in the service area at year-end means that the standard will necessarily be fluid from year to year.

Moreover, the terms used to describe different levels of performance include "roughly comparable," "significant amount," and similar words that are anything but precise. These general standards have been proposed, in part, to avoid giving specific numbers which would risk resulting in the specific allocation of the amount, type, or terms of credit institutions must provide.

Institutions will have to speculate about the activities of their compatitors, and examiners will be forced to interpret these terms on a case-by-case basis, when evaluating individual institutions. Thus, an institution may have some of

the same uncertainty about how its performance will be evaluated that it has now. To same extent we will always be plagued by the dilemma of how to provide better guidance and certainty in the CRA area without reducing needed flexibility. But we expect these issues to be resolved over time although ultimately the experience may prove frustrating to both financial institutions and community groups.

- There may be problems associated with the "market share" test. One such problem may result from the fact that the market share for other than mortgage loans will be computed only in comparison to other depository institutions who must report data. Leaving out small depositories (generally under $250 million in assets) and nondepositories, the percentage of those who are subject to CRA and included in the market share comparison will be low. In some localities, a very few or even a single institution may be included in the "market." This could cause practical problems and anomalous results.

- The new requirement for summary reporting of the number, amount and geographic distribution of small business, mortgage and some consumer loans is a significant one. It is important to the goal of making the CRA process more quantifiable; yet it could be costly. For covered commercial banks, the annual cost for the small business portion of the data collection alone has been estimated by our staff to approach $21 million. In all, about 3,400 institutions will be required to gather new data.

Because of these concerns, we have also asked for a discussion of burdens and benefits of this requirement in the public comments.

- The appropriateness of the streamlined review procedure for small institutions under $250 million in assets will surely be questioned in the comments -- as well as the impact of the presumption that such small institutions have a "reasonable" loan-to-deposit ratio if it is 60 percent. We have heard from the small banks who have commented on the proposal thus far that this is an unrealistically high loan-to-deposit ratio for them, especially for good quality loans, and we have some concerns that small institutions who want to benefit from the streamlined CRA review might be forced to imprudently change their lending standards in order to meet this presumption.

- There are other potentially controversial aspects to our proposal, such as whether the alternative evaluation for banks with preapproved plans is workable, whether the role of the public and community groups in development of the plans is adequate, and whether we, in fact, should be treating institutions receiving low ratings as being in violation of the regulation and subject to our enforcement authority. These important issues will also receive considerable attention by us and, I hope, by the public.

Discussion of Specific Issues Raised in Letter of Invitation

In addition to many of the issues I have already addressed in my statement, I would like to respond to some of the questions raised in your letter of invitation:

- The Appeals process: Financial institutions have always been able to request supervisory personnel at Reserve Banks to roview the ratings issued by examiners--whether involving CRA or other supervisory issues--but we do not consider this a formal appeals process. We anticipate that our informal system for appeals would complement the opportunities for input in CRA evaluations. The proposal would permit institutions to rebut presumptive ratings under the lending, service and investment tests. But the proposal also provides that the agencies would announce upcoming examinations in order to get public comment on an institution's performance. These comments, and those in the institution's public file, would be taken into account in our assessment of their performance.

- Frequency of examinations for institutions rated "outstanding": The proposal does not address examination frequency. Our current policy, however, does allow evaluations to be conducted less frequently for outstanding-rated institutions. Presently, state member banks rated outstanding, with at least satisfactory ratings in consumer compliance in general, are examined once every eighteen to twenty-four months, compared to the six- to twelve-month examination frequency for

poor performers. At this point, I would assume that we would maintain our current policy even with regulatory changes.

- Effect of investment credits and indirect lending on ratings: Under the proposal, investment activity by retail banks could help to increase their base rating in the lending test, up to two levels if the investment performance is outstanding. Investments will be the sole criteria for measuring the performance of wholesale and limited-purpose banks, however. Indirect lending activity may be taken into account under either the lending or investment tests. These aspects of the proposal are controversial, and of particular concern to community groups. We will be evaluating their comments very carefully as we consider what the appropriate treatment of investments and indirect lending should be.

- Effect of ratings and public involvement on applications: CRA ratings, as well as public comments on applications, can and do influence significantly the Board's consideration of an institution's application. This has been made clear in earlier CRA policy statements. The proposal is more explicit than our current regulation about the effect different ratings will have on the Board's consideration of an application. For example, under the proposal, an "outstanding" would be looked on very favorably and a "substantial noncompliance" rating generally would result in the denial of the application. We are aware of the concern of community groups that there may be an implicit "safe harbor" in the proposal. A

"safe harbor" was not intended, and to the extent that there is any misunderstanding, it will be clarified in the final version.

Conclusion

Through our internal review of CRA and the public hearings on CRA reform, we have been afforded a unique opportunity to step back and take a fresh look at the enforcement of one of the most important, yet controversial, laws affecting financial institutions. In proposing our comprehensive regulatory reform of CRA, we have been highly aggressive in approach. Our efforts are bound to generate a good deal of debate and concern -- for example, that we are demanding too much or not enough, that we have been too specific or too vague, and that we have been too sensitive to small banks' concerns about paperwork burden or not sensitive enough.

As I said during the Board's public deliberations on the proposed amendments to our CRA regulation, although I take a natural pride of authorship given the time I have invested with my colleagues, I am not unalterably wedded to this specific proposal. If the public comment points out serious flaws, particularly in the areas of operations or implementation, or if better ideas emerge, I am perfectly willing to recommend to my fellow regulators and members of the Board of Governors that we return to the drawing board. We should not hesitate to do so if that is the way to ensure that we have done the best job possible. To give the public anything less than the best is a goal that no one involved in this process would condone.

TESTIMONY OF

ANDREW C. HOVE, JR.
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

PROPOSAL TO REFORM THE COMMUNITY REINVESTMENT ACT REGULATIONS

BEFORE THE

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

10:00 A.M.
TUESDAY, FEBRUARY 8, 1994
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Good morning, Mr. Chairman and Members of the Subcommittee. On behalf of the Federal Deposit Insurance Corporation ("FDIC"), I welcome this opportunity to testify on the proposal to reform regulations that implement the Community Reinvestment Act ("CRA"). I also will update the Subcommittee on several fair lending initiatives undertaken by the FDIC.

I. Observations on the CRA Reform Effort

I would first like to make some general observations about the CRA regulatory reform effort.

In July 1993, President Clinton requested that the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision ("agencies") undertake sweeping reform of the CRA regulations, after consultation with depository institutions, community organizations and others throughout the country.

The CRA regulatory reform effort has involved a more comprehensive process than undertaken for the development of most depository institution regulations. First, the agencies held public hearings at seven locations across the country during August and September of last year. We heard testimony from over 250 witnesses, with nearly 50 others submitting written testimony. Next, these comments were synthesized and many are

reflected in the proposed rule which was published in the Federal Register on December 21, 1993. The comment period on the proposed rule has been extended to March 24, 1994.

In order to ensure maximum comment on the proposal, the FDIC has mailed the proposal to all FDIC-supervised institutions, approximately 7,300, and to over 2,000 community organizations and coalition groups nationwide, asking for their comments. FDIC staff have encouraged banks and community groups to provide comment at recent community development and fair lending conferences in Massachusetts, Illinois, Missouri, California, Puerto Rico and the District of Columbia and are doing so elsewhere. We are urging interested parties to comment on what they like in the proposal, as well as what they do not like. We are asking for alternative recommendations and advising that interested parties may comment on the entire proposal or only on what is of concern to them. We bslieve it is important to take the time needed to carefully evaluate the comments and refine the proposal appropriately.

Most of the witnesses at the public hearings, including the regulators, agreed that in the past we have focused too much on process. The banking agencies over the past couple of years have attempted to addrees this complaint by issuing guidelines to examiners and institutions which clarify requirements, downplay paperwork requirements, and focus attention on meeting the intent

of CRA -- making credit available within all communities. Nevertheless, in our meetings across the country there was a common message that not enough attention was being placed on whether loans were being made and services were being provided.

I think there is general agreement that we can improve upon the way we implement the CRA. Banks and thrifts are not satisfied with the current regulations because they focus too much on process and documentation. Many bankers complain that CRA regulations, together with other regulatory requirements, leave them little time to do the very thing the CRA is meant to encourage them to do -- make loans. Individuals and community organizations feel that more emphasis needs to be placed on results and that we need more data to confirm that institutions are producing those results.

The proposed CRA regulation issued by the banking agencies would focus our efforts on results. Institutions would be evaluated based on their performance in the areas of lending, investment and the provision of services. Small institutions would have a streamlined examination process but, here too, the focus would be on results. Clearly, the direction we are going is to place greater weight on the loans, investments and services banks and thrifts have actually provided to their communities, especially low- and moderate-income areas, and less weight on showing us the efforts they have made.

I think this direction is good. However, I would like to add a cautionary note. In changing our focus to results, greater emphasis will be placed on formulas, ratios and other standards to compare the performance of insured institutions. These may provide fair comparisons for many institutions. However, I doubt that we could write a formula to evaluate CRA performance that would be fair to all institutions or the communities they serve one hundred percent of the time. We believe the proposed regulation will allow examiners to make justifiable exceptions where the performance measures do not make adequate allowance for individual circumstances. We will be most interested in comments that address whether the proposal strikes the appropriate balance in this area.

II. Issues Raised by the Proposal

I would now like to turn to the issues which the Subcommittee requested that we address in our testimony -- issues that are particularly important in implementing community lending standards.

1) **The process established in the regulations for a financial institution to appeal a CRA rating.**

The proposed regulation would not establish a new process for a depository institution to appeal a CRA rating. It does

reiterate formally an institution's right to provids additional information or comment before a CRA rating becomes final. The proposal provides that the preliminary ratings of an institution under the three tests that measure landing, investment and service performance are "subject to rebuttal." Under the present system, at the conclusion of the onsite portion of the FDIC's CRA examination, preliminary findings are communicated by the examiner to the institution at a meeting with its senior management or, if problems are noted, with its board of directors. Then, the examiner's findings and recommendations are carefully scrutinized by senior review examination staff at the FDIC regional office before a final CRA rating is determined. During this review period, there is sufficient time and opportunity for an institution to react to the preliminary findings and to provide additional information. The proposed regulation explicitly restates an institution's right to the review process.

2) The lessening in frequency of CRA examinations for institutions which achieve an "Outstanding" CRA rating.

There is no provision in the proposed CRA regulations which addresses the frequency of CRA examinations. However, in the preamble to the proposal, the agencies discuss the possibility of less frequent examinations for institutions that show strong performance in order to create an incentive to improve

performance. We seek public comment on this suggestion.

The FDIC's current guidelines provide for CRA examinations of institutions rated "Satisfactory" or "Outstanding" at least every two years. Institutions that are rated "Needs to Improve" or "Substantial Non-compliance", however, will undergo an examination at least once each year with additional visitations conducted as necessary. We do this primarily to ensure that timely corrective actions are undertaken by problem institutions.

3) The modification in CRA requirements for institutions under $250 million in assets which meet specific criteria.

An issue of particular importance to the FDIC is the provision allowing small institutions the option of a streamlined assessment method. Small institutions are defined in the proposal as having total assets of less than $250 million. As the regulatory agency responsible for supervising approximately 65 percent of the institutions with under $250 million in total assets, the FDIC would like to make clear that the proposed streamlined assessment method would not constitute an exemption for small institutions. Many small institutions and their representatives have urged that the agencies exempt small institutions from CRA assessments. As stated in the proposal, the agencies do not believe that an exemption is permitted by the

statute. Furthermore, we believe that an exemption would be unwise because it may result in the neglect of credit needs of some communities that are served by small institutions.

Under the proposed streamlined method for small institutions, examinations would not become mere formalities or simple reviews in which examiners quickly determine whether the institutions have met the items on a checklist. Although small institutions would not be required to either geo-code loans or report consumer, small business or small farm loan data, examiners would be required to determine if an institution has a reasonable loan-to-deposit ratio, makes the majority of its loans locally, and makes a variety of loans across all income levels. In addition, if the institution is required to report loans under the Home Mortgage Disclosure Act ("HMDA"), the institution would be required to have a reasonable geographic distribution of reported loans. Examiners also would consider whether or not an institution has engaged in illegal lending discrimination that it has not corrected or is in the process of correcting fully.

In an attempt to further streamline the process, small institutions would be able to decide whether a regulatory agency considers, in addition to its lending record, the institution's record of making qualified investments and its provision of branches and other services to low- and moderate-income persons in its service area. This would not, however, exempt small

institutions from making a reasonable variety of loans across all income levels or the agencies from our responsibility to attempt to measure this lending performance.

We are very interested in comments concerning these results-oriented standards for small banks, such as "reasonable" loan-to-deposit ratios and "reasonable" geographic and income distributions of lending, and whether they are addressed in a way that would allow us the flexibility to take into account differences among the size and capabilities of institutions and also the varying needs of their communities.

4) **The role that credit for investment in certain activities will have on composite CRA ratings.**

Generally, institutions over $250 million in asset size would be evaluated by three tests that measure their lending, investment and service performance, each of which could affect the composite CRA rating for an institution. The investment test would consider an institution's investments in community and economic development activities and would also take into account investment partnerships with community development organizations. Activities like these allow institutions to lend in low- and moderate-income neighborhoods by injecting the capital often missing in such neighborhoods. These investments also better enable lenders to qualify for the federal, state and private

funding or insurance programs that provide capital. Increased capital will provide the borrower equity necessery to encourage increased lending levels in low-income, or moderate-income neighborhoods, in a safe and sound manner.

A retail institution's rating under the lending test, which evaluates whether an institution lends throughout its community, forms the basis for its composite rating. To provide an incentive for a retail lender's participation in community development activities, however, the institution's base rating would be increased by two levels if the institution has an "Outstanding" investment test rating, or by one level if it has a"High Satisfactory" investment test rating. A wholesale or limited purpose institution, which does not make residential, consumer, small business or small farm loans, would not be evaluated under the lending test. Instead, the investment test would form the basis for its composite CRA rating. Finally, a small institution, electing to be evaluated under the streamlined assessment method, would be able to decide whether an agency considers the institution's record of investment in addition to its lending record.

The composite CRA rating of an institution also can be affected by its rating under the service test. As an additional incentive for improved performance, the base rating would increase by one level if the institution has an "Outstanding"

service test rating and decrease by one level if the institution has a "Substantial Noncompliance" service test rating. The service test evaluates the accessibility of branches and the extent to which the institution provides other services that enhance credit availability.

5) The reporting of small business lending data by larger institutions.

The objective of the agencies is to devise clearer requlations that focus more on results than process. In order to evaluate the results of an institution's lending effort rather than the process used, an examiner must know something about the types of loans the lender originates, how many, in what amount, and where. The proposal would require the collection of loan data to measure these results. Large institutions with more than $250 million in total assets would be required to report information on the geographic distribution of certain consumer loans, small business loans and small farm loans. Data on applications and their disposition would be reported by census tract allowing examiners to measure loans in low-and moderate-income or other areas.

One aspect of the proposal is the requirement that institutions identify loans to small businesses with 1) average annual gross receipts of less than $250,000; 2) average annual

gross receipts of $250,000 or mere but less than $1 million; 3) average annual gross receipts of $1 million or more but less than $10 million; and 4) manufacturing businesses with average annual gross receipts of $10 million or more but less than 500 employees. Including small business credit as a key component of "reportable" loans reflects its pivotal role in the economic development process in low- and moderate-income areas. Under the proposal, banks and thrifts would be required to explicitly identify small business lending both within and outside of low and moderate-income areas. The costs and benefits of requiring banks and thrifts to collect or report data on small business lending has been the subject of discussion for some time now. We look forward to comments on the costs and feasibility of this approach.

6) **The function of community groups and other members of the public in developing strategic plans.**

The proposal allows an institution the option to submit for agency approval a strategic plan as an alternative to being rated after the fact under the lending, service and investment tests or the small bank assessment method. The plan would detail how the institution proposes to meet its CRA obligation using measurable goals. This alternative method is intended to provide an institution with some degree of certainty about the acceptability of its CRA approach. Notice of the proposed plan would be widely

published by the institution in each of its communities, copies of the plan would be available for review at the institution's offices, and public comments may be submitted to the institution's regulatory agency. This will allow community groups and others an opportunity to review the plan and provids the agency with comments prior to agency approval. This will also provide institutions an opportunity to seek valuable input from community organizations during the development of a strategic plan.

7) **The role that indirect lending will play in CRA assesements.**

An institution could elect to have the agencies consider indirect loans under the lending test. Indirect loans include permissible loans or investments made to third parties that lend to low- and moderate-income individuals or areas, such as affiliates of the institution, lending consortia, minority-owned institutions, low-income credit unions and community development lenders. The proposal makes a distinction between the recognition of indirect loans by its affiliates and indirect loans by the other lenders. The institution could claim credit for the lending of affiliates under rules of the lending test regarding proportionate shares, whether it invests in the entity or loans to it. For other third party lenders, however, the institution would be required to have made a permissible equity

investment in the entity in order to claim any credit under the lending test for its loans. Any loans or investments that an institution reports as indirect lending under the lending test could not be counted again as qualified investments under the investment test.

The purpose of this provision is to recognize the unique quality of indirect lending activity, the need that exists for it in low- and moderate-income areas, and to enhance an institution's flexibility to meet this important need. We believe that it is these types of locally-based partnerships and cooperative efforts that are most productive in revitalizing depressed communities.

8) The effect of ratings on bank applications, and public involvement in the application process.

When considering an application, the CRA rating assigned to an institution is an important and often controlling factor because it indicates how well an institution has fulfilled its requirement to meet the convenience and needs of the community. Under the proposal, a "Needs to Improve" CRA rating, absent any demonstrated improvement over time in performance or other factors, generally would result in the denial or a conditional approval of an application. A "Substantial Noncompliance" rating

generally would be so adverse a finding as to result in denial of an application.

Public involvement in the application process will continue to be of paramount importance. As under the present system, a public comment pariod will allow for comments, endorsements or protests. There are no "safe harbor" provisions in the proposal that would exempt an institution from this public application process due to its CRA rating.

III. The FDIC's Fair Lending Initiatives

Since 1990, the FDIC has undertaken a series of important initiatives to improve fair lending supervision. These include the formation of a separate Compliance Examination Program within our Division of Supervision and a Community Affairs Program within our Office of Consumer Affairs. In recent months, we have evaluated organizational structure, policies and procedures impacting fair lending supervision; taken a new look at examination procedures and other tools to detect and prevent illegal discrimination; and improved administration of the consumer complaint process. We have developed recommendations to improve fair landing and community reinvestment performance through both examiner training and increased communication with depository institutions, community organizations and other agencies.

Let me briefly touch on some of the most recent initiatives:

- An Assistant Regional Director in each of our eight regions of the Division of Supervision is being dedicated solely to the management of the compliance and fair lending function. Until now, Assistant Regional Directors who managed this function had additional responsibilities. There are now approximately 300 compliance examiner positions at the FDIC compared with 150 when the separate Compliance Examination Program was implemented in early 1991. More will be added as necessary. Each region also maintains a separate Compliance Examination Review staff with specific responsibility for the compliance and fair lending examination function.

- The FDIC's Fair Housing Examination Procedures were significantly revised last year. Directions for the extensive use of HMDA data and a comprehensive review of loan files and loan policies are incorporated in the procedures to help detect evidence of illegal discrimination or disparate treatment.

- The FDIC is undertaking increased use of targeted fair lending examinations. Last month we began a HMDA Disparities Investigation Project to review racial and ethnic disparities in denial and application rates reported by FDIC-supervised institutions nationwide for the 1992 calendar year. This special targeted effort involves experienced senior level staff from the

Division of Supervision and the Office of Consumer Affairs. Extensive review procedures have been set out to ensure that all institutions with high disparity rates for minorities will undergo a review to discover the reasons for the disparities and identify those institutions exhibiting possible illegal discriminatory behavior.

- Improved examination tools are now available to examiners. For example, HMDA Analysis Reports customized for each institution and specific geographic areas are being provided for regional and field office use. HMDA Examination Tables, summarizing an institution's reported data and designed to assist examiners in studying the data, were recently installed on easily accessible computer networks in each region. Complete 1992 HMDA Disclosure Reports for all reporting institutions will soon be available on CD ROM to examiners. Census Tract Maps and CD ROMs with census tract level demographic data have been purchased from the Bureau of the Census to assist examiners in forming judgments on an institution's lending patterns across racial, ethnic and economic areas in each locality. Other related products that have been developed for examiner use include a series of Wide Area Census Tract Profiles which provide an analysis of the racial and ethnic populations, income levels and housing characteristics by census tracts.

• The Office of Consumer Affairs has expanded the Community Affairs staff in each region to include a Fair Lending Specialist. Fair Lending Specialists assist the Community Affairs Officers in each region in acting as a liaison between community groups, lenders and the FDIC on the fair lending process. The Fair Lending Specialists are also a resource for compliance examiners on matters concerning HMDA data analysis, lending discrimination and community development. We have also added a Fair Lending Specialist to the Washington staff of the Office of Consumer Affairs.

• Fair lending testing guidelines have been developed and are under review for release next month. The guidelines are intended to be a self-help guide for depository institutions on how to improve fair lending performance and self-test for illegal discrimination and disparate treatment in the loan application process.

• The Consumer Complaint and Inquiry System, an automated system for tracking the number end nature of complaints and inquiries, has been revised to provide more complete timely information on the nature of consumer complaints and inquiries so that we are better able to monitor them for timely response and potential problems.

• FDIC Fair Lending Roundtables will be convened by the Office of Consumer Affairs and the Division of Supervision in communities throughout each of our eight regions on a periodic basis. Roundtable meetings will bring together a variety of representatives from depository institutions and community organizations with specific knowledge of fair lending and community development issues to establish a dialogue with our examination staff, identify barriers to fair lending and discuss ways to overcome them.

• We are actively coordinating with HUD, DOJ and the other financial institution regulators on enforcement of fair lending laws, such as the Fair Housing and the Equal Credit Opportunity Act. We intend to be an active participant in the President's new Fair Housing Council and continue to work with other federal agencies to affirmatively further fair housing.

• Finally, in order to better implement the FDIC's Equal Employment Opportunity Policy and to improve diversity in our workforce, affirmative action accountability has become a specific element in the performance evaluations of the FDIC's managers and supervisors. We have also conducted Multicultural Awareness and Sensitivity training over the past 12 months for staff of several of its Offices and Divisions including senior management levels and examination staff. This training increases sensitivity to stereotyping and resultant discrimination of all

types. We have recommended to lenders that they conduct similar training to help identify possible illegal discriminatory practices.

IV. Conclusion

In conclusion, the FDIC believes that strong fair lending actions by the banking industry, supervision by its regulators and partnership efforts with community groups and individuals are critically important to making the Community Reinvestment Act work. We look forward during the public comment period to receiving comments that will assist in developing regulations that in the President's words, "increase investment in communities that need it, while simultaneously streamlining and clarifying the regulatory process." We are mindful of our responsibility to promote safe and sound banking, and of the recognition in the Community Reinvestment Act that banks have an obligation to help meet the credit needs of their entire communities, including low- and moderate-income communities. We believe that both of these goals are attainable.

EMBARGOED
until Feb 8, 10 am

Testimony

of

Jonathan L. Fiechter, Acting Director

Office of Thrift Supervision

concerning the

Community Reinvestment Act

before the

Subcommittee on Consumer Credit and Insurance

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

February 8, 1994

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INTRODUCTION

Mr. Chairman and members of the Subcommittee, I am pleased to provide the Office of Thrift Supervision's (OTS) views on President Clinton's Community Reinvestment Act (CRA) Reform Initiative.

My testimony will describe our efforts, in conjunction with those of the other Federal financial supervisory agencies, to establish and implement the President's CRA initiatives. My testimony will also summarize significant elements of the proposed CRA regulations, discuss issues that are relevant to our reform efforts and the effectiveness of CRA generally, and address the questions posed in your invitation letter.

I believe that credit can be used as an engine for economic growth and revitalization. Communities, financial institutions, and government can form a partnership and work together to energize this needed growth and revitalization by making credit and financial opportunities available to all people in all communities throughout this nation. At the same time, I believe we can also reduce unnecessary regulatory burdens on financial institutions.

As you know, President Clinton initiated the CRA reform effort last summer when he asked the Federal agencies responsible for the administration and enforcement of the CRA to seek ways to improve their evaluation standards and examination procedures. The President specifically asked us to: (1) work with bank and thrift institutions, the public and Congress to develop a new approach to CRA that emphasizes performance rather than documentation; (2) develop a well-trained corps of examiners specialized in CRA; (3) promote consistency and fairness, improve performance evaluations and institute more effective sanctions against poor performers; and (4) focus new evaluation standards on three types of community reinvestment activities - lending, investments and services.

The agencies' reform efforts are guided by three primary goals: (1) to improve CRA performance by focusing the regulations on making credit and financial services available to all communities, particularly underserved areas throughout urban and rural America; (2) to reduce regulatory burden by having clearer and more objective evaluation standards that emphasize performance over documentation; and (3) to promote consistency in examinations and enforcement.

Following seven public hearings on the CRA, the agencies developed a proposed regulation using the broad outline given by the President and the comments we received from the public hearings. The proposal, which was published for comment on

December 21, 1993, attempts to achieve the agencies' CRA reform goals. We are looking forward to the comments of industry representatives, community groups and other interested parties on whether the proposal accomplishes its stated objectives and where it can be improved.

As of the end of January, OTS had received only twenty-four comments on the proposal from a variety of interested parties, including thrifts, state-chartered banks, national banks, industry consultants, and a member of Congress. Most of these letters are from small institutions and focus on one or two issues. These small institutions generally welcome the proposal's streamlined examination process but raise concerns about the eligibility criteria for such examinations. We expect more comment letters to be submitted toward the end of the comment period.

The comment period, originally scheduled to end on February 22, 1994, was recently extended to March 24, 1994. We anticipate that the final regulation will be issued by late spring.

SELECTED ELEMENTS OF THE PROPOSED REGULATION

Evaluation Tests

The most significant difference between the current CRA regulations and the proposal is the replacement of twelve assessment factors to determine CRA compliance with three performance-based tests: lending, investment and service. Institutions would generally be evaluated on the basis of the product lines offered to their customers in the normal course of business. For most institutions the lending test would be the primary basis for measuring performance. The investment and service tests would serve to augment performance under the lending test.

The lending test evaluates an institution's direct lending in low- to moderate-income and other areas. The test compares the institution's market share of loans in low- and moderate-income geographies to its market share in the remainder of its service area. It gives "extra credit" to institutions for making complex or innovative loans that serve pressing community development needs without undermining safety and soundness.

An institution may also elect to have its indirect lending evaluated under the lending test. Indirect loans are those made by third parties such as:

- lending consortia,
- subsidiaries of the institution,
- nonchartered affiliates of the institution that it assists in funding, and

o women- or minority-owned institutions, low-income credit unions, and other lenders in which the institution has made lawful investments.

If an institution elects this option, its indirect loans would be evaluated in proportion to its investment, taking into account both the total lending by the third party and the lending done by the third party in the institution's service area.

The proposal distinguishes between the ability of an institution to claim credit under the lending test for indirect loans by its subsidiaries and affiliates, and its ability to claim credit for indirect loans made by other lenders. An institution could claim credit for the lending of subsidiaries or affiliates whether it invests in the entity or makes a loan to it. For other third-party lenders an institution would be required to have made an investment in the entity to claim credit under the lending test for its loans. This distinction therefore recognizes the unique relationship between an institution and its subsidiaries and affiliates, and enhances the flexibility of institutions and their parent corporations to structure their community development lending programs. The agencies specifically ask for comment on whether indirect loans should be included in the lending test, and whether their proposed treatment is meaningful, workable and effective.

The investment test evaluates an institution's record of qualified investment in organizations and initiatives that foster community development, small- and minority-owned business development, or affordable housing lending, including state and local government agency housing or revenue bonds.

The service test evaluates whether branches are accessible to low- and moderate-income areas and whether services promote the availability of credit. It gives special consideration to accomplishments or programs that provide greater access to credit, capital or services. Providing services such as low-cost check cashing, "lifeline" accounts and credit counseling can also work to improve an institution's CRA rating.

We asked for comment on this three-test approach. Specifically, we are interested in:

o whether those who work with CRA believe that the lending, investment and service tests are meaningful and workable as a way of measuring actual performance;

o whether the proposal has struck the appropriate balance between the need for certainty in the system and the need for flexibility to reflect an institution's service capabilities and credit needs of the community; and

- how performance under these three tests should be measured. For example, we are open to suggestions on whether the quantitative measures used in the tests should be expanded to include a broader array of performance measures.

In addition, we are interested in knowing what, if any, analytical or computational problems result from the requirement to calculate relevant ratios under the lending test using only loans made by institutions that would be required to report their lending, rather than loans made by all lenders in the relevant markets. One possible problem may be that in some instances the "market share" test may not be an accurate reflection of the true market. For example, the percentage of lenders subject to CRA and included in a market share comparison for a given area may be low because both small institutions and lenders other than depository institutions would not be reporting data.

Alternative Assessment Methods

Another significant feature of the proposal is the availability of two alternative assessment methods. The first is a streamlined examination for small institutions (defined as independent institutions with total assets under $250 million or institutions with total assets under $250 million that are subsidiaries of a holding company with total banking and thrift assets under $250 million). The streamlined examination would consider an institution's loan-to-deposit ratio, whether most of its loans are made locally, its loan mix (including the distribution of loans across income levels), its record of community complaints and substantive compliance with the fair lending laws.

The streamlined examination does not constitute an exemption from the CRA's requirements for small institutions, and we do not envision a streamlined examinat on as a mere formality. We expect our examiners to carefully review an institution's performance within the framework of a streamlined examination. The streaml ned exam nation process should benefit small thrifts and the communities they serve to the extent that it will allow those thrifts to redirect scarce resources from additional data collection to community lending.

The second alternative assessment method, a strategic plan, is available to all institutions. Strategic plans would have measurable goals and would be submitted to an institution's regulator for approval. Notice of a proposed plan would have to be published in a newspaper of general circulation in the affected communities. Regulators would consult with community groups to decide whether a particular plan is respons ve to community credit needs, and any comments received from community groups would be taken into account in

the agency's assessment of the plan. If an institution fails to meet the preponderance of goals set forth in the plan, its performance would be evaluated under the lending, investment and service tests.

Regulatory Burden

The focus of the proposal on performance has allowed us to propose eliminating some procedural requirements. Institutions would no longer have to prepare CRA statements, review them annually, or document them in minutes of the board of directors meetings. Regulators would no longer require institutions to justify the basis for community delineations or to document efforts in marketing or the ascertainment of community credit needs. However, institutions that do not elect or are not eligible for the small institution streamlined assessment method would be required to report data on the geographic distribution of their small business and some consumer loans.

Data on small business loans would be reported based on the sales volume of the business. Data on race and gender of borrowers would not be collected and reported, except to the extent such data are required by current law. Data would be reported in summary form and submitted to the agencies by January 31 of the calendar year following the calendar year for which the data were collected.

The additional data collected on small business and consumer loans will be made available to the public along with Home Mortgage Disclosure Act (HMDA) data. The proposal also continues the practice of making CRA evaluations public.

Enforcement

The CRA requires the OTS to take into account the CRA performance record of institutions in considering applications for deposit facilities. The proposal is more specific than the current regulations in exactly how the CRA rating will be considered. In addition to evaluating CRA performance in the applications process, the proposal specifically imposes upon depository institutions the continuing and affirmative obligation to help meet the needs of their entire communities, including low- and moderate-income areas, consistent with safe and sound operations. It also provides that institutions assigned a composite rating of Substantial Noncompliance are subject to enforcement actions pursuant to 12 U.S.C. 1818, including the issuance of cease and desist orders and the imposition of civil money penalties.

Transition Period

Evaluation under the revised CRA standards would not be mandatory until July 1995. Institutions may elect to be

assessed under the new methods prior to that time. Data collection under the regulation would begin shortly after it is finalized.

We will be working throughout the transition period to revise our CRA examination procedures, train our compliance examiners, and provide consistent guidance on the new regulation to the industry.

EXAMINATIONS AND RATINGS

The Subcommittee's invitation letter asks us to address the role that credit for investment in certain activities will have on composite CRA ratings, the process established in the regulations for institutions to appeal their CRA ratings, the frequency of CRA examinations for institutions that achieve an outstanding CRA rating, and the effect of ratings on applications.

CRA Composite Ratings

Generally, an institution is assigned one of five ratings for its performance under each of the three evaluation tests: Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, and Substantial Noncompliance. A retail institution's rating under the lending test forms the basis for its CRA composite rating. This base rating may be increased by two levels if the institution has an Outstanding rating in the investment test or by one level if it has a High Satisfactory rating. The base rating may also be increased by one level for an Outstanding rating in the service test, or decreased by one level for a rating of Substantial Noncompliance.

The rating would then be converted to the four-level rating system required by the CRA. High Satisfactory and Low Satisfactory ratings are both scored as Satisfactory in reaching the final composite rating. An institution's Needs to Improve rating would be changed to Substantial Noncompliance if it received no better than a Needs to Improve rating on both of its last two examinations. Finally, the composite rating would be adjusted to take into account illegal lending discrimination by the institution.

Where an institution operates in more than one service area, the agencies will conduct evaluations in a sample of all the service areas in which the institution operates. Separate composite ratings will be assigned on each of the evaluated service areas. The overall rating for the institution will reflect the performance of the institution in the evaluated service areas.

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Appeals Process

The agencies recognize that the proposed regulations represent a dramatic change in existing practices and encourage open and frank dialogue of all aspects of an institution's CRA performance. The proposal specifically encourages institutions to consult with the agencies on compliance with the new standards. In addition, the proposal permits an institution to rebut its preliminary rating assigned under the three evaluation tests. The proposal also encourages liberal use of the agencies' existing appeal processes.

The OTS currently has a supervisory review process in place that we expect to use to resolve issues that may arise under the new regulation. This process establishes a three-step review for resolving substantive matters that are inconsistent with existing OTS policies and procedures or have not been resolved to the institution's satisfaction.

- First, institutions are encouraged to express any disagreement arising during an on-site examination directly with the examiner-in-charge while at the institution. Comments supporting the institution's position may be included in the final report of examination.

- Second, if a disagreement cannot be resolved during the examination, institutions are encouraged to directly contact the appropriate OTS regional office.

- Finally, if a disagreement still has not been satisfactorily resolved, an institution may file an appeal with our Washington office. We will request any additional information within 15 days and make a decision within 30 days of the original request or receipt of additional information.

Examination Frequency and Ratings

The agencies believe that a link between examination frequency and an institution's CRA rating provides us with a sensible way to allocate limited examination resources. We believe that our attention needs to be focused on institutions with lower ratings. The agencies also believe that a shorter examination frequency for institutions with low CRA ratings may serve as a performance incentive.

Under our present compliance examination procedures, savings associations rated Outstanding or Satisfactory for CRA are examined on a two-year cycle, associations rated Needs to Improve are examined on a one-year cycle, and associations rated Substantial Noncompliance are examined every six months.

Our policies also permit more frequent examinations where warranted.

<u>Effect of Ratings on Applications</u>

The CRA requires the agencies to consider the CRA performance record of an institution in considering applications by the institution for a deposit facility. The proposal does not change this long-standing requirement, but does explain how the CRA ratings will be considered in certain types of applications.

Along with assessing safety and soundness concerns, the CRA rating would continue to be an important and often controlling factor in assessing an application. The proposal recognizes, however, that other information related to CRA performance is also relevant and should be considered. For example, information collected through public comment and through periodic and special reports might be especially helpful in evaluating an application.

As proposed, ratings of Outstanding and Satisfactory would generally mean that the CRA aspect of an application is consistent with an application's approval. A rating of Needs to Improve would generally be an adverse factor in the CRA review of an application. This rating would generally result in conditional approval or denial of an application, absent demonstrated improvement in the institution's CRA performance or other countervailing factors. A rating of Substantial Noncompliance would generally result in denial of the application.

DISCUSSION

I would like to discuss two issues that are relevant to our regulatory reform efforts and the effectiveness of the CRA generally.

First, OTS fully supports the effort to revitalize our communities through reinvestment. The thrift industry can and is making a significant contribution to community reinvestment by providing credit and basic financial services. Nonetheless, the thrift industry is only one small segment of the financial system that needs to be mobilized to solve the nation's community development needs.

In the last five years, the thrift industry's market share in 1-4 family mortgage originations has dropped from 38 to 18 percent as private mortgage companies and other lenders increase their market shares. These trends raise the question of whether nondepository institutions should share in the responsibility for community development in some way.

Second, if we are to successfully increase the flow of credit to areas of need in our country, we must make certain that we are doing all that we can at the Federal level to reduce any barriers to such lending. Solving the problems of depressed and underserved areas of the country requires the coordinated efforts of government, industry and private citizens, all acting in partnership with a common goal.

We need to ensure that the various Federal, state and local government programs are coordinated and accessible to all institutions and the public. Currently, were a thrift to take on the challenge of developing a neighborhood or block in its community, there would be a number of state and Federal programs that are available to assist with this lending. But there is no one place that the thrift could go to find out about these programs and services. OTS has begun to address part of this market inefficiency in our affordable housing initiative announced last spring. We are committed to encouraging safe and sound lending for affordable housing by examining and removing any regulatory or programmatic barriers to such lending and to work with institutions who are interested in doing more affordable housing lending.

CONCLUSION

The goal of our CRA reform effort is to encourage lending in low- and moderate-income areas by reducing the paperwork burden on thrifts and measuring performance rather than process. We firmly believe that this goal is attainable within the bounds of safe and sound banking practices.

One of my personal goals during this reform process is to dispel any concerns that savings associations have had under the current regulations, or may continue to have that compliance with the CRA jeopardizes safety and soundness. That is simply not true. In fact one of the underpinnings of the proposed regulation is the recognition that an institution's CRA obligation must be met using prudent business practices. The proposal does not encourage or expect a liberalization of underwriting standards to the detriment of safe and sound lending principles. It does, however, encourage institutions to be innovative in attempting to create products to meet the various needs of a diverse customer base.

The interagency proposal is a significant departure from the way in which the CRA has been administered in the past. As a result, we expect substantial public comment on the proposal. We would be pleased to share what we learn from those comments with the Subcommittee as the regulatory process continues.

NAVAJO NATION WASHINGTON OFFICE

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Testimony of the Navajo Nation

Before the

House Subcommittee on Consumer Credit

and Insurance

of the

Committee on Banking, Finance and Urban Affairs

on Proposed Regulations to Reform the

Community Reinvestment Act of 1977 (CRA)

February 8, 1994

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Testimony of the Navajo Nation Before the House Subcommittee on Consumer Credit and Insurance of the Committee on Banking, Finance and Urban Affairs on Proposed Regulations to Reform the Community Reinvestment Act of 1977 (CRA)

February 8, 1994

Introduction

Good morning, my name is Marshall Plummer and I am Vice-President of the Navajo Nation, the largest American Indian tribe in the United States. On behalf of the Navajo Nation and President Peterson Zah, I would like to thank Chairman Kennedy and the members of tha Subcommittee for conducting this hearing on the proposed federal regulations to reform the Community Reinvestment Act of 1977 (CRA). The Navajo Nation would also like to commend the Clinton Administration and the federal financial supervisory agencies for undertaking this much-needed effort of reforming the CRA.

On October 21, 1993, I testified before this Subcommittee and outlined the tremendous need for CRA reform that would address the unique lending issues on the Navajo Nation and in Indian country. The Navajo Nation remains concerned, however, that the proposed regulations are likely to remain ineffective when addressing some of the distinct banking issues prevalent on the Navajo Nation and Indian country. In my statement today, I would like to share some of the Navajo Nation's concerns with the proposed CRA regulations, and offer some recommendations to ensure that solutions to banking and credit needs of American Indians are included in reforming the CRA.

Background

Profile of the Navajo Nation

The Navajo Nation is the largest American Indian tribe in the United States, with a total population of 219,198 enrolled members (13 percent of all Indians nationwide). The Navajo reservation is also the largest in size (36 percent of all Indian lands in the lower-48 states), spanning more than 17 million acres across three states: Arizona, New Mexico and Utah. Our land base is comparable in size to the state of West Virginia.

Socio-economic conditions on the Navajo Nation are comparable to those found in underdeveloped third world countries because of the lack of a strong private sector economy, due in large part by the lack of a solid financial infrastructure. According to the 1990 Census, the percentage of Navajos living below the poverty level was approximately 56 percent as compared to approximately 13 percent for the entire United States. Overall, the average Indian reservation unemployment rate--on reservations located in 32 states across the country--is 56 percent.

Housing statistics on the Navajo Nation are equally alarming. In 1993, the number of Navajo families needing new housing was approximately 20,996[1]. Of this total, it is estimated that the total number of families waiting for new houses was 13,539. Many of these Navajo families are currently living with extended families in overcrowded conditions thereby creating undue hardship on the homeowners. The remaining 7,457 families are currently living in houses that are in such poor condition that they warrant complete replacement. In addition, it is estimated that 18,427 housing units are in sub-standard condition because they lack either running water, indoor plumbing, electricity and/or central heating.

Economic and Community Disinvestment

Currently the Navajo economy is experiencing a massive amount of economic leakage that is directly attributable to community disinvestment. More than $700 million dollars per year escapes to neighboring border towns which serve as Navajo regional shopping centers. Many Navajos are forced to travel long distances to border towns and metropolitan communities such as Albuquerque, New Mexico or Phoenix, Arizona to purchase almost all of their basic goods, including food, clothing, vehicles, farm equipment, and the like. Important services such as automobile repair, laundry and recreational opportunities are also

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[1]According to Navajo Housing Services, Navajo Division of Community Development, 1993.

predominately found in outlying communities. This translates into a loss of jobs for Navajo communities and an increase in the economy for the off-reservation border towns and metropolitan areas. Income spent outside the reservation in municipalities such as Gallup and Farmington, New Mexico are taxed at the point of sale with all sales taxes utilized for the benefit of that municipality and not necessarily for Navajo citizens.

Furthermore, many middle income Navajos residing on the reservation, oftentimes can only secure financing on mobile homes or must move to off-reservation border towns and metropolitan areas to purchase homes because banks are reluctant to provide financing for new home construction on the Navajo reservation. As a result, these Navajos, who otherwise qualify for new home loans or comparable loans off the reservation, also purchase goods and services in the border towns in which they reside. Some of these goods and services may be available on the reservation which further contributes to economic decline.

Banking and Financial Services on the Navajo Nation

A financial infrastructure is virtually nonexistent in the Navajo Nation except for three banks in Shiprock, New Mexico and Window Rock and Tuba City, Arizona. The disparity of banking services available to Navajo residents is evident when one drives through a border town such as Gallup and observes in existence, at least eight banks for a community which has a population of not more than approximately 20,000. On the other hand, the Navajo Nation, with a population of more than 200,000 has only three existing banking facilities on the reservation at this time. As a result, the vast majority of Navajos on the reservation lack access to capital and financing for personal, small business and industrial development purposes.

The lack of financial institutions has created a tremendous hardship on tens of thousands of Navajo people, many of whom must travel up to four hours round-trip to the nearest facility for basic banking services. Because of the long distances, it is not uncommon for many Navajo employees to take leave from work to deposit or cash their paycheck. Despite this tremendous inconvenience, our communities continue to grow, further increasing the need for financial institutions. Navajo savings and checking deposits are on the rise in those banks that are located on the reservation as well as those found in neighboring border towns. Yet, credit opportunities for Navajo banking customers and business owners are still severely limited or non-existent.

Credit Terms on the Navajo Nation

Due to the lack of access to credit, many Navajos are forced to seek financing from many non-financial institutions. For example, in order to purchase

an automobile, many Navajos must seek credit through automobile dealers in outlying border towns instead of financing through more traditional financial institutions such as banks or credit unions. Although no statistics are available, the Navajo Nation firmly believes that this type of financing often results in worse credit terms for Navajo consumers with shorter term loans, higher monthly payments and higher interest rates. As a result, the Navajo Nation believes that repossession rates of such business entities are artificially higher because credit through banks or credit unions is not available.

Overreliance on Federal and Tribal Programs

As mentioned before, the lack of a strong private sector economy forces many Navajos to rely heavily on federal and tribal assistance programs to provide basic living needs. For example, adequate housing is extremely scarce on the Navajo Nation, and one of the major barriers to increased housing development is a lack of financial resources. In addition to not providing commercial or business loans, many banks are also unwilling to engage in mortgage lending for new home construction on the reservation. This places a tremendous burden on many federal agencies, such as the Department of Housing and Urban Development (HUD) and tribal governmants in attempting to provide adequate housing for Navajo families.

Due to the shrinking federal budget and increased need for housing throughout the United States, these federal and tribal housing programs cannot fulfill the tremendous need on the Navajo Nation. Therefore, in order to foster community development by increasing the amount of new home construction and repair on the Navajo Nation, federal policies, such as the CRA, need to be revamped to seek innovative methods of financing for Indian country.

Developing a Self-Sufficient Economy

As previously stated, financial resources for community and economic development are extremely limited on the Navajo Nation and have therefore severely dampened tribal initiatives to foster community and economic development. Therefore, it is vital to the future of our people that banks and/or community development financial institutions be incorporated into the Navajo Nation's economy.

The Navajo Nation is currently working to accelerate the development of an on-reservation private sector by encouraging the creation and expansion of small businesses, expanding tourism and attracting industrial development to the reservation. These efforts will require significant capital and financing to pay for wages, raw materials and other costs, making financial institutions on the Navajo Nation a virtual necessity. However, if successful, these initiatives will assist in decreasing the amount of disinvestment and economic losses and increase

employment.

Need for CRA Reform on the Navajo Nation and Indian Country

Historical Perspective of the CRA

Since its enactment, the CRA of 1977 has never been a productive mechanism in fostering economic and community development in underserved areas throughout the United States. It has remained even more ineffective with respect to the Navajo Nation and Indian country since it has never addressed the specific credit and service needs of Indian country. As a result, CRA assessments have permitted banks to refrain from providing adequate banking and financial services to the Navajo Nation and Indian country because it has never been necessary in order to receive an adequate rating. Consequently, the Navajo Nation and Indian country in general, continue to be among the most disinvested areas in the United States.

Barriers to Accessing Credit on Indian Reservations

A major barrier to achieving an appropriate amount of credit and financial services on reservation lands is that most of the land is held in trust for tribes by the federal government. Consequently, this has subjected banks to the difficulties of perfecting loans to which the federal government holds ultimate title. Banks, realizing they cannot foreclose on the federal government generally have chosen not to extend lending opportunities to reservation areas. While the trust land issue has presented some difficulties in reservation lending, specifically home mortgages, banks have expanded their non-lending policies to include most forms of consumer, commercial and business loans. This includes loans that do not require substantial collateral.

In addition, most of the banks in and around the Navajo Nation have stated that repossession is a big problem for their businesses in terms of collecting their collateral or property. Yet the Navajo Nation has a repossession law which is available as a remedy to Navajos and non-Navajos. Further, the Navajo Nation has an approved Commercial Code that governs general business transactions generally. The Navajo Commercial Code was designed, in part, to address bank concerns and encourage them to become more active in lending on the Navajo Nation (Navajo laws and tribal court decisions are published and available). Attorneys at the Navajo Nation Department of Justice can assist banks and others that have questions or require further information. In short, the Navajo Nation is willing to be flexible and creative in its efforts to facilitate an environment conducive to increasing banking activities.

However, banks have not acted alone in the prolonged practice of non-

lending to reservations. The federal financial supervisory agencies have allowed banks' policies of non-lending on the Navajo Nation and Indian country to exist and even expand by providing them with acceptable CRA ratings. This is based on banks' contentions that by originating loans on reservations they would be subjected to an unreasonable amount of high risk, increased cost and unacceptable time delays. Without any statistical evidence to support such a claim, federal financial agencies have generally not held banks accountable for failure to provide adequate lending or banking services, by not rating banks poorly on their CRA assessment evaluations. Therefore, the original Congressional intent for the CRA to address credit needs for home mortgages and commercial purposes throughout America has completely bypassed the Navajo Nation and Indian country.

The Navajo Nation's Involvement with the CRA

Despite our misgivings concerning the CRA, the Navajo Nation has used the CRA recently with great success in our successful negotiations with Norwest Arizona in purchasing Arizona's Citibank. In addition, Eugene Ludwig, and the Office of the Comptroller of the Currency, have played a pivotal role along with an outgoing bank president who was reasonable and willing to listen to our concerns. The result was a letter of commitment from Norwest to the Navajo Nation which aims to significantly improve banking services throughout the Navajo Nation by originating $60 million in loans over the next ten years, and building a new bank in Tuba City, Arizona to replace the existing trailer. Norwest has also agreed to establish new branches in Kayenta and Chinle, Arizona, and improve the branch in Window Rock, Arizona. Finally, Norwest plans to install ATM machines at all of these locations.

We are optimistic and hopeful that Norwest will fulfill the goals set forth in its commitment letter to the Navajo Nation, and we stand poised to assist Norwest in achieving these banking improvements and lending standards. In spite of this, the Navajo Nation remains apprehensive because of previous negotiations with banks.

While the Navajo Nation has only begun utilizing the CRA for only a short time since its enactment, the Nation now recognizes it as a potentially effective mechanism to assist in our community and economic development efforts. For these reasons and many more, we have entered in the arena of public debate on the CRA.

Proposed Regulations

The Navajo Nation believes that the proposed CRA regulations will generally encourage a higher degree of actual lending, service and investment throughout many underserved areas in the United States. It is not clear, however, if these

regulatory improvements will result in greater economic opportunities for American Indian people. The Navajo Nation firmly believes that the present CRA regulations provide very little incentive for a bank to increase its lending, service and investment activity on Indian reservations. This may also be true to a lesser degree for other rural and urban areas which can argue, rationally and intelligently, they too have not received the benefit of the spirit and intent of the CRA.

Under the proposed regulations, much emphasis has been placed on small banks, presumably for the purpose of relieving them from baing overburdened by the CRA process. In doing so, small banks will become the major beneficiaries from this reform by being excluded from data collection and by a "streamlined" CRA evaluation.

Since small banks make up the majority of those located in and around the Navajo Nation and Indian country, the Navajo Nation is concerned with this focus on alleviating small banks from many of the same CRA standards required for larger banks. The Navajo Nation feels that most small banks will continue to approach the federal financial supervisory agencies with the same premise that non-lending to Indian reservation areas is borne out of a business necessity.

Furthermore, federal financial supervisory agencies may continue to accept this line of reasoning, negating any potential benefits the Navajo Nation and Indian country may receive from this reform process. Therefore, the language included in the proposed regulations, which provides that the CRA does not require any bank to make loans or investments that are expected to result in losses or are otherwise inconsistent with safe and sound banking operations, needs clarification. The Navajo Nation is concerned that the language is too broad and ambiguous, and in order to be more effective, language must be included to specifically address Indian issues as is done in other regulatory matters. This will assist in ensuring that American Indian communities, and American Indian people, are given every consideration by the banking industry and the federal agencies when providing banking and financial services.

Recommendations

The Navajo Nation has done an analysis of the proposed CRA regulations and will continue to be involved in the reform process by maintaining a consistent dialogue with the federal financial supervisory agencies, Congressional members, and community groups. In addition, the Navajo Nation will be submitting its comments to the federal financial supervisory agencies on the proposed CRA regulations on the appropriate deadline date. As a result of our analysis, the Navajo Nation proposes the following recommendations on how the CRA regulations should be revamped to address the specific lending and banking service needs of American Indian people.

1) **Reservation Banking Study**

Due to the lack of comprehensive statistics and information on the unique financial circumstances and needs in Indian country, the Navajo Nation recommends that the four federal financial supervisory agencies conduct a thorough study on reservation banking and lending. Financial institutions and federal agencies do not possess a comprehensive understanding of the lack of banking services and its impact on American Indians. Results from such a study would provide much-needed insight on the specific financial circumstances found in Indian country and should then be disseminated to federal agencies who administer or oversee programs on or near Indian reservations including HUD and the Department of Justice.

2) **Eliminate Streamlined Method and Disclosure Exemptions for Small Banks**

Since small banks are basically the major holders of potential credit on the Navajo Nation and Indian country, and because of their reluctance to focus on Indian reservation financial needs, the Navajo Nation recommends that small banks and thrifts in and around Indian reservations not be exempt from providing data on the geographical distribution of their loan applications, denials, origins and purchases to the public. The potential for the public to monitor their community's bank activities will strongly encourage an increase in lending, service and investment performance to take place from that bank. Additionally, this will provide tribal leaders with the opportunity to determine if tribal members are actually the recipients of the lending activity or, if in checkerboard areas, non-Indians living within a reservation are the recipients of lending activities. Without this important data on Indian reservations, where wholesale discrimination is most likely to occur, the public as well as the federal financial supervisory regulators will be less likely to become aware of any isolated or class acts of illegal discrimination.

3) **Require Data Collection for Small Banks Located on or Near Indian Reservations**

The Navajo Nation recommends that small banks located on or near Indian reservations not be exempted from the data collection requirements. Since we are only beginning to explore the role of banking in reservation communities, the need for quantifiable measurements are needed to assess banks' progress, identify lending patterns as wall as service trends and to plan for the future. If necessary, because of the tremendous need and because of the federal trust responsibility over Indian tribes, the data collection efforts may need to be subsidized by the federal government concerning reservation areas if the concern is to avoid a disproportionate share of the cost burden of small banks compared to large banks. Geographic data collection is therefore critical to the success of addressing credit issues of Indian reservations.

4) Clarify Safe And Sound Definition to Include Circumstances in Indian Country

The Navajo Nation urges the federal financial supervisory agencies to provide a clarifying statement in the proposed CRA reform language contained in 25.6 (c) to ensure that the unique circumstances on Indian reservations and Indian country cannot solely be construed by banks to be inconsistent with safe and sound operations. Banks located on or near the Navajo Nation have benefitted from the ambiguity of this statement by using it to justify non-lending practices on the Navajo Nation.

5) Provide Incentives for Institutions that Relocate or Expand Services on or near Indian Reservations

Improve lending, service, and investment tests by providing incentives that would help boost CRA ratings for financial institutions that relocate or expand their services on or near Indian reservations. Given the decades of absence in addressing banking issues on reservation areas by not only the banking industry but also by the federal financial supervisory agencies, this would allow banks to increase their CRA assessment for the expansion of facilities and ATM's on reservation lands. In addition, these incentives would permit banks to improve their CRA assessments for participating directly with tribel governments in identifying credit barriers and implementing actions to alleviate those problems. Incentives for increasing the amount of lending on Indian reservations would greatly enhance tribal efforts at economic and community development and strengthen the private sector economy of the Navajo Nation and Indian country. With improved lending and banking services on the reservation, thousands of Navajos who presently have to travel up to four hours, round trip, to the nearest bank would benefit substantially.

6) Provide Incentives for Banks that Utilize Federal Programs Addressing American Indian Needs

Other incentives that would help boost CRA ratings should be implemented for banks that utilize and coordinate their lending efforts with established government loan guarantee programs of particular interest to American Indian tribes and American Indian people. For instance, banks should be awarded for activities such as becoming an approved lender of guaranteed loans from the Bureau of Indian Affairs and the Farmers Home Administration, Housing and Urban Development Programs, and other government programs which are of special interest to American Indians. This would provide the motivation and incentive needed for banks to address Indian concerns. Presently, these programs exist but not all banks on or near reservation areas are participants.

7) **Improve Training for CRA Examiners**

Federal supervisory agencies must provide bank examiners with proper training on the unique characteristics of lending issues on or near Indian reservation areas. This would allow examiners to independently assess and evaluate CRA ratings for banks on or near reservations without unfair influence from the banking industry. This will also provide bank examiners with better insight into the desperate need for banking lending services on or near Indian reservations.

8) **Redefine Multiple Service Territories to Include Indian Country**

Provide necessary language that will ensure that bank examiners pay particular attention to the delineated service territories of a bank located on or near a reservation when conducting a bank's CRA evaluation. This would ensure that the reservation is not being illegally omitted from a bank's service area. Cases known to us indicate that banks which are subjected to scrutiny by the federal financial supervisory agencies regarding lending and services on reservation property have included activities by those banks to attempt to redraw their delineated service area or to exclude reservation areas from those already drawn so as to avoid any accountability for reservation areas in regards to the CRA.

9) **Provide Consultation Mechanisms for Communities and Tribal Governments that would affect a Bank's CRA rating**

As currently drafted, it is vague how much consideration would be given to comments of community members or tribal governments if they did not approve of a bank's positive CRA rating. The Navajo Nation recommends that more weight be placed on the comments of American Indian communities and tribal governments that would affect CRA ratings for banks located on or near reservations. In addition, the new regulations should require that tribal governments and community members have a specific opportunity to offer input and review the proposed plan of action regarding a potential effort to increase banking activities in an area on or near an Indian reservation.

10) **Coordinate Efforts with the United States Department of Justice**

The Navajo Nation recommends that the federal financial supervisory agencies coordinate efforts with the Department of Justice to eliminate illegal lending discrimination. Recently, the United States Department of Justice settled a lawsuit that was brought about involving the Blackpipe State Bank in South Dakota. In a press release dated January 20, 1994, the Justice Department indicated that in November of 1993, Blackpipe State Bank was sued by the Justice Department for allegedly refusing to make secured loans where the collateral was located on an Indian reservation, for placing credit requirements on American

Indians that it did not require of non-Indians, and because Indians were charged greater interest rates and finance charges than non-Indians were. Attorney General Janet Reno indicatad that this was the first lawsuit of its type to ba brought on behalf of American Indians, and said tha investigation focused on the unique problems people on the reservation have in obtaining credit.

11) Establish a Task Force to Coordinate Lending Efforts with the Federal Financial Supervisory Agencies

Specific language should indicate that a task force or commission, made up of the various department heeds having special government guaranteed programs, will be established to coordinate with the federal financial supervisory agencies those activities which will result in a greater coordination of efforts in regards to addressing the special unique characteristics of lending, service and investment issues relative to Indian reservation lands.

Conclusion

In order to assist tha Navajo Nation and other American Indian tribes improve the current standard of living throughout Indian country by developing self-sustaining private sector economies, and decreasing the overreliance on federal programs, it is vital that current efforts at reforming the CRA include specific strategies that address the unique lending characteristics on the Navajo Nation and Indian country.

If however, specific improvements--directed to improving the specific lending and banking issues prevalent on the Navajo Nation and Indian country--are not included in the proposed CRA regulations, socio-economic standards on the Navajo Nation and Indian country in general, will continue to remain among the lowest in the United States. The accumulative result, an increase in unemployment and poverty on Indian reservations, will continue without the aid of a well developed private sector. By necessity, the Navajo Nation is looking to this nation's financial institutions, the federal financial supervisory agencies and Congressional members to conduct this reform in a coordinated and cooperative effort to ensure that the unique economic and community needs of American Indian people are addressed. Thank you for the opportunity to testify today. The Navajo Nation looks forward to working with you in the near future.

CRA REGULATORY REFORM:

OF INCLUSION

Testimony for the
U.S. House of Representatives
Subcommittee on Consumer Credit
and Insurance
of the Committee on Banking
Finance and Urban Affairs

By Rev. Charles R. Stith, National President
Organization for a New Equality

February 8, 1994

CRA REGULATORY REFORM: THE ILLUSION OF INCLUSION*

Last year President Clinton charged the nations' bank regulators with the task of revising the Community Reinvestment Act so that the regulations would focus on performance rather than process. The fundamental principle the President felt should guide this effort was that the CRA should result in equal access to credit, capital, and services for the minority community and other capital-starved communities. The effect of this reform was to be the inclusion into the economic mainstream of those who historically have been mired in the economic swampland.

Reform of the CRA was necessitated by discriminatory practices by banks. This has been documented by such varied sources as:

• The Atlanta Constitution newspaper 1988 study showing that a white high school drop-out had a 60% better chance of getting a mortgage than a black person with a graduate degree;

• The First District Federal Reserve Bank study of Mortgage Lending in Boston based on 1990 HMDA data documented a 3:1 disparity in the declination of home mortgages for minorities.

The effects of these practices are more startling than the details of the discrimination itself.

* Testimony presented by Rev. Dr. Charles R. Stith, National President, Organization for a New Equality and on behalf of the National Community Reinvestment Network, with affiliates from communities of color in over 80 cities and towns across America.

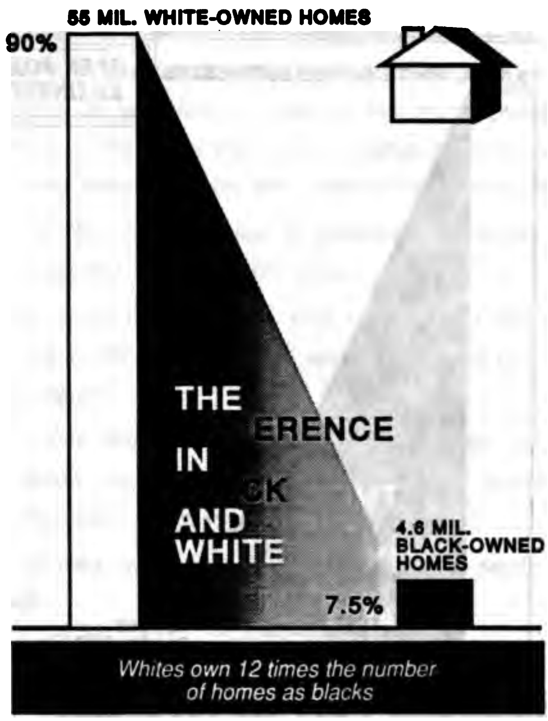
In 1987 (the most recent date for which complete figures exist), whites owned 30 times as many businesses as African Americans.

COMPARISON OF BUSINESS OWNERSHIP BY RACE

1987 U.S. DEPT. OF SMALL BUSINESS ADMINISTRATION

Whites own 12 times the number of homes as African Americans. (It is worth noting that the rate of homeownership for African Americans in 1990 is 42%; which does not equal the rate of homeownership for whites in 1890, which was 51%!)

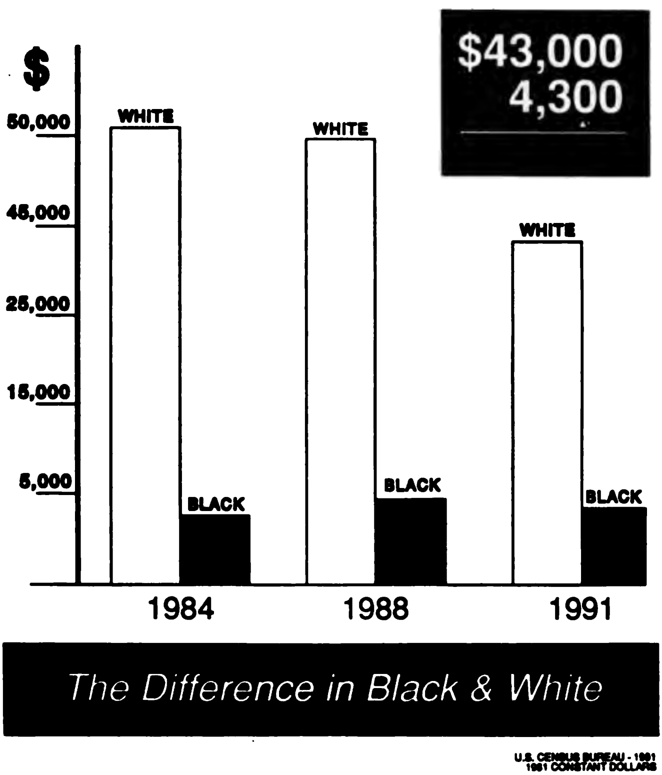
COMPARISON OF HOME OWNERSHIP RATES BY RACE



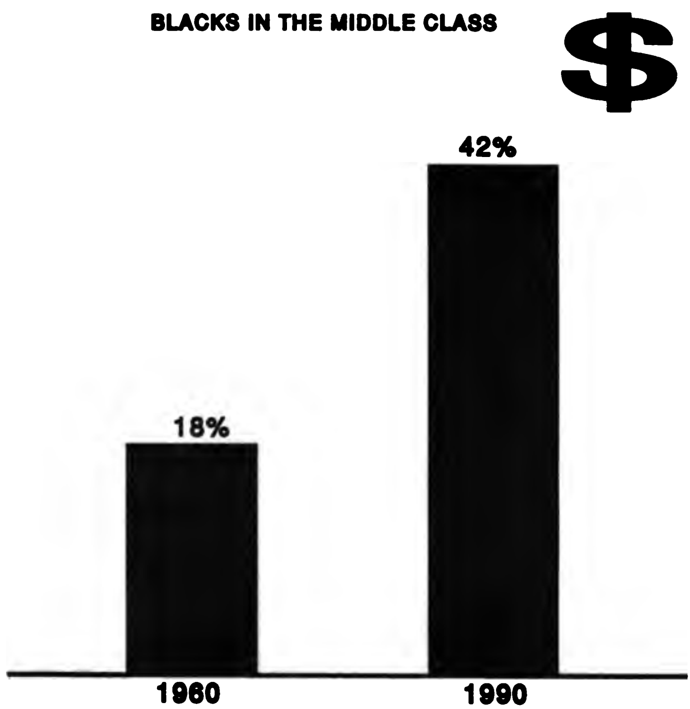
FACT: Black mortgage applications are rejected at more than 2 times the rate of White.

These disparities translated into terms of net worth result in the average white family in America being worth $43,000 while the average Black family is only worth $4,300.

MEDIAN NET WORTH BY RACE



The irony of this disparity in net worth is underscored by the growth of the Black middle class. In the past thirty years Black membership in the middle class has increased 300%.



Black membership in the middle class has grown 300% in the past 30 years

While the CRA Reform Proposal as packaged promises that minorities will be included as full participants in the financial marketplace and that banks will pursue fairer practices; in fact, what it really offers is the "illusion of inclusion."

There are three critical flaws in the proposed package which preclude it from resulting in the degree of fairness in lending and services that would enable the minority community to begin to close the equity gap which exists between it and the white community.

1.) There is a Failure to Significantly Deal with Race as a Factor in Determining or Evaluating CRA Compliance

While the proposed CRA reform package makes reference to HMDA in the evaluation process; it is ambiguous as to how to interpret what HMDA means relative to the evaluation, or what weight is to be given to the data in determining a bank's compliance with CRA.

The failure to deal with race as a factor is further underscored by not requiring the collection of race specific data for small business loans.

The failure to collect small business data to reveal the race of the borrower makes it impossible to mitigate or monitor discrimination against minority business owners and entrepreneurs. To simply measure a bank's market share of business loans by zip code or other geographic measure would do nothing to remedy the problem of racial discrimination against minority entrepreneurs and business owners who want to operate in communities of color.

2.) The Rating System is Flawed

At the core of CRA compliance is the credibility of the composite rating system. The proposed system could obscure the lack of a lending relationship by a retail bank with communities of color and other low and moderate income communi-

ties. Because a bank's composite rating could be raised by two levels for an outstanding rating on the investment test, and by one level for an outstanding on the service test; a bank could get a "Needs to Improve" on the lending test and still receive an overall outstanding rating.

Another shortcoming of the proposed plan is that it allows a bank to appeal its CRA rating, but it does not afford the same opportunity to community based organizations.

A third problem with the rating system is the vagueness of the qualifiers used to determine the ratings themselves, for example terms like "very significant," "very little," "insignificant," do little to objectively clarify what an institution must do to be in compliance.

3.) Community Groups are Marginalized in Terms of CRA Compliance

The option of banks developing strategic plans in consultation with the "community" as a way of fulfilling their CRA commitments sounds promising, but it is also problematic. The principle problems being the lack of resources and capacity of many grassroots community organizations to evaluate the appropriateness of a CRA plan and to monitor such a plan after it is agreed to. The resource issue became very clear for us when we requested HMDA data from BancOne and their response was that we would have to pay over $400 to get it! While O•N•E as a national organization could afford this cost, many of our member organizations could not. What's more, even if they could get the data, the ability to analyze it properly poses a substantial barrier for many groups.

The point is this: relative to the banks, community groups lack resources. Communities lacking effective CRA advocates can have the bank define its CRA plan without effective community input. Banks, in soliciting input on strategic

plans can afford to play one group off against another. Once the CRA plan has been approved, even the most sophisticated community groups have difficulty monitoring compliance.

Finally, community groups are marginalized because there is no formal mechanism for soliciting input during either the examination process or the development of a bank's strategic plan.

O•N•E's 10 Recommendations for Reforming the CRA Regulations

1.) HMDA data must be used as a factor to determine market share parity under the lending test.

2.) Collection and reporting of HMDA-like data for small business loans must be mandatory for all banks.

3.) Small business lending to racial minorities must be used to determine market share parity under the lending test.

4.) Community groups must be given the right to appeal inflated ratings.

5.) Community input should be sought by regulators as part of the examination process and by banks at the outset of the development of their CRA Strategic Plans.

6.) Quantifiable measures should be assigned to qualifiers to fairly measure a banks' performance.

7.) No retail bank which performs poorly on the lending test should be given a passing final grade.

8.) Minority hiring and the appointment of minorities to a bank's Boards of Directors should be used as factors in the service test.

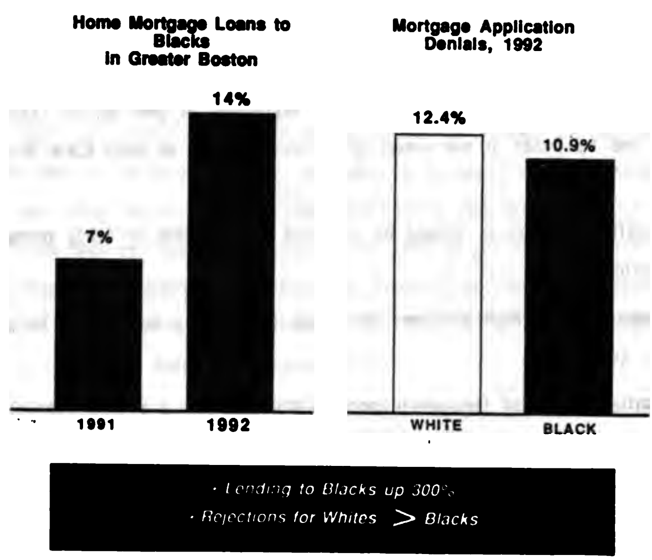
9.) Minority procurement should be used as a factor in the investment test.

10.) Banks should be given credit under the investment test for support of CRA advocacy groups.

Conclusion

While there are going to be honest differences of opinion in the debate about reforming CRA, we should remember that our deliberations are not taking place in a vacuum. We should not be timid about taking bold action to correct age old inequities because there is evidence that CRA can work. It can be profitable for banks and beneficial for individuals in communities that cling to the hope of realizing the American Dream. The Bank of Boston has demonstrated that dramatic change is possible. In just one year the bank did three times as much mortgage business in the African American community as it did the year before; with no disparity in the

CASE STUDY OF PROGRESS: The Bank of Boston



declination rate.

Finally, let me underscore that what is at issue here is something more than can be reflected in charts and graphs. It is something more fundamental than that which is expressed in cold, staid, statistical terms. What is at stake is the ability of people of color in this country to fashion a financial future for our families, to revive our communities, and save our children.

The name of the economic game in America is not just income, but equity; it's not just what you have, but what you own. Unless we have access to the capital, credit and services of banks and S&L's, the American Dream will be beyond our grasp. The flaws in the present proposal must be corrected lest we're left with the "illusion of inclusion" rather than a real option of opportunity.

TESTIMONY

of

TERRY J. JORDE

PRESIDENT/CHIEF EXECUTIVE OFFICER
TOWNER COUNTY STATE BANK
CANDO, NORTH DAKOTA

on behalf of the

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 8, 1994

Mr. Chairman, I am Terry Jorde and I am President and CEO of the Towner County State Bank in Cando, North Dakota. I am also Vice-Chairman of the Bank Operations Committee of the Independent Bankers Association of America and I have been nominated to serve as the IBAA's Treasurer. The IBAA is the only national trade association that exclusively represents the interests of community banks.

The Towner County State Bank is a small bank serving Main Street America and American agriculture. We have $24 million in assets and 12 employees, serving a town of 1500 people. There are thousands of banks throughout the Midwest and the nation carrying forward this important role. I am personally involved in community support activities, serving on the board of our county hospital and the board of an economic development corporation. My activities are typical of an involved community banker. I am aware of similar activities throughout my state because the governor has appointed me to the Board of the North Dakota Department of Banking and Financial Institutions.

We appreciate the opportunity to testify about the Administration's proposed Community Reinvestment Act regulations. They respond to the President's directive to improve the CRA process in ways that "minimize the compliance burden on financial institutions while stimulating improved CRA performance."

The CRA reform initiative was based on the recognition that CRA is one of the most burdensome and least effective regulations. We commend the regulators for recognizing that local community banks shouldn't be under the same paperwork requirements as multinational and multistate institutions. We strongly support the proposed streamlined examination process for banks under $250 million.

My testimony today will discuss this feature of the regulations, as well as other key aspects. In the near future the IBAA will be submitting formal comments to the agencies and I ask that you accept these comments into the record of this hearing.

A TIERED REGULATORY SYSTEM

The current CRA enforcement scheme treats large, multinational and regional banks the same as community banks. This is unjustified. Both the banks and the markets they serve are completely different. About the only thing my bank has in common with Bankers Trust or J.P. Morgan is the fact that we both accept deposits and have commercial bank charters.

In 1991 the Financial Institutions Subcommittee recognized this fact and adopted an amendment offered by Representative Kanjorski exempting from CRA all institutions under $150 million in assets and all rural institutions under $250 million. The full committee dropped the proposal in a deal with the Bush Administration over an unrelated provision. The current proposal builds on the principle behind the Kanjorski amendment -- that community banks are, by definition, committed to serving their markets -- while maintaining the requirement that all institutions comply with CRA.

While the Community Reinvestment Act covers all sizes of institutions, it is flexible. The statute provides regulators with ample authority to ease the compliance burden imposed on community banks.

Some have claimed that the proposed streamlined examination system for banks under $250 million in assets is inconsistent with the legislative history of CRA. However, there was no discussion or reference in any of the committee reports or floor debate which indicates that all banks had to undergo an identical enforcement scheme. And, the legislative history makes clear that the Act was not intended to require banks to do any additional paperwork. The proposed streamlined examination process is completely consistent with this original intent by significantly cutting back the paperwork requirements for smaller banks. This is justified by the fact that different sized banks have differing abilities to comply with regulations.

Community bankers strongly support the goal of CRA--investment in our communities. Many community banks serve low-to-moderate income residents since they make up the great majority of our market. This is where we work and live. CRA as it is presently administered detracts from banks serving these communities by emphasizing a paper trail rather than ongoing lending performance.

Our bank recently completed a CRA examination by the FDIC and received an "outstanding" rating. It is hard to argue with success, but I want to point out that it was very costly and time consuming for our bank to obtain this rating. Examiners did give us credit for helping beginning farmers to obtain loans from the Bank of North Dakota and for the many other community development programs that we promote. But, they also looked at our CRA file which included a lot of paperwork intended to show that we are trying to determine our community's needs and offering products to meet those needs. This is very burdensome for my bank which has only 12 employees. Although we are proud of our "Outstanding" rating, I can honestly tell you that all of the extra paperwork and documentation did not result in even one more loan being made in our community. All it does is take up the critical time that our staff could better spend outside of the bank working directly with members of our community. That sort of paperwork is unnecessary; if we don't know and meet our community's needs our community won't survive, and neither will we. It's that simple.

It is our hope--and our prayer--that CRA reform significantly reduces the paperwork burden while enhancing the lending and investments of the relatively few community banks that need improvement.

We believe a tiered system is consistent with President Clinton's request for an improved CRA process. On July 15, the President said a CRA "system too inflexible to recognize the real differences among the circumstances in which our banks and thrifts operate would poorly serve both our financial system and our communities." The proposed CRA revisions differentiate between multinational and regional institutions serving large,

metropolitan areas, and the community banks serving small towns and rural areas.

Small town America has the "other side of the tracks" in their towns. Other small towns are comprised almost solely of low- and moderate-income families. What is often overlooked is that the small town community bank must serve both sides of the track if it is to survive, and more importantly, if its community is to survive. This is because in many small town communities, a large number of residents have low- to-moderate incomes.

Existing regulatory policies make modest acknowledgements about the need to differentiate between small banks and large banks. Yet, most often, no meaningful burden-reducing distinctions are made. Community bankers repeatedly testified during the regulators' CRA hearings that they are being held to the same standard--in terms of documentation and paperwork as their larger competitors. Banks with staffs of 10 are being asked--and are expected--to do the same as those with staffs of thousands. Banks in towns of 1,000 are being held to standards that parallel those for multinational financial corporations operating nationally and serving the world.

What public purpose is served by a regulatory system which discriminates against community banks by inflicting them with the same regulatory burden as multi-billion institutions? What public purpose is served by a regulatory structure that threatens the very existence of small community banks, and yes, even the communities they serve?

STREAMLINED EXAMINATION PROCESS

Not an "Exemption"

The $250 million streamlined examination process is not an "exemption." In proposing this plan the regulators recognized that while community banks must continue to comply with CRA, they cannot bear the same paperwork burden as larger banks. Under the new system CRA examiners will look at a community bank's actual lending record. Examiners will no longer require a bank to prove that it is trying to serve its community. Instead, examiners will determine whether the bank is actually serving its community by reviewing the bank's loan files.

Problems With the 60% Benchmark

The streamlined examination system has a serious flaw, however. To gain a satisfactory rating a community bank must have a 60% loan-to-deposit ratio, which is presumed to be reasonable.

There are a number of serious problems with any fixed ratio in a regulation intended

to apply nationwide to banks serving many different markets. A fixed ratio fails to account for differences among local markets and for the ebbs and flows of activity within markets.

Many areas lack sufficient loan demand, making it impossible to meet an arbitrary 60% test. For example, one rural bank cited a number of reasons why its loan-to-deposit ratio is below 60%:

- farmers who survived the agriculture crisis of the 1980s are reluctant to borrow;

- housing costs are much lower than in urban areas so loans are smaller and run for shorter terms;

- real estate often changes hands by land sale contract between buyer and seller which cuts capital gains taxes and, incidentally, generates no loan demand; and,

- many rural customers are older people who have substantial savings and do little borrowing.

These factors would likely affect thousands of banks in rural and small-town America. It makes no sense for examiners to impose the 60% benchmark and then require these thousands of banks to demonstrate that a lower ratio is reasonable.

In addition, many markets, particularly rural areas, experience significant seasonal variations as farmers take out loans to plant crops or businesses buy inventory and then repay the loans later in the year. A fixed loan-to-deposit ratio would not adequately reflect these seasonal variations.

My bank provides an excellent example of this. We make every good loan we can, mostly for agricultural purposes. The following table shows how our ratio fluctuates on an annual basis due to the seasonal patterns of agriculture:

1993	January	44.76
	February	44.49
	March	45.76
	April	48.74
	May	50.67
	June	57.52
	July	62.05
	August	64.38
	September	64.60
	October	64.48
	November	61.64
	December	55.92

1994 January 50.68

My bank's loan-to-deposit ratio has ranged from 44.5% to a high of 64.5%. If my bank was examined in August under the proposed regulation we would be rated "Satisfactory," but if examined in January, we would come under intense scrutiny. I would have to keep all the required documentation in order to plead my case if we were examined in the winter. Keep in mind that we were examined this winter and still received an Outstanding rating. Clearly, our loan-to-deposit ratio was considered, but other factors were more relevant.

I do not believe that averaging our loan-to-deposit figures, as some have suggested, would accurately reflect the credit demands in Cando and the needs we have met. We clearly have a predictable annual cycle in my market; but other markets may have very different cycles, depending on the lines of business that are important in those areas. A simple averaging rule could not be sensitive to those differences.

The loan-to-deposit benchmark also ignores much of a bank's community reinvestment activity. Banks are increasingly originating loans and selling them into the secondary market. This activity helps banks' communities but does not show up in the ratio. As I indicated, we received CRA credit for helping three farmers get Beginning Farmer Loans from the Bank of North Dakota. No portion of these loans is carried on our books. We also participate in a program which helps our lower-income customers get long-term, fixed-rate real estate mortgages with very low down payments. The loans are sold on the secondary market and our bank receives just $100.00 per loan for our services. Since we pay a $1000 per year fee to HUD to participate in the program this is clearly a service, not a profit center. These are the types of activities CRA encourages, yet none of them are reflected in the bank's loan to deposit ratio.

Similarly, community banks effectively lend to local municipalities for infrastructure development by purchasing municipal bonds. These are not counted as loans. Banks also make considerable investments in collateralized mortgage instruments and mortgage-backed securities (CMO & MBS). These investments allow banks to support long-term home lending without taking long-term interest rate risk.

Our bank also originated and participated out to other banks $2,690,000 in loans. We did this to stay under our lending limit or to provide our customer with a lower interest rate. If these loans were added to our own, it would increase our loan-to-deposit ratio by more than 12 percent.

If the proposed 60% loan-to-deposit test were adjusted to take these factors into account it would make a vast difference to many other banks. For example, IBAA's President, Jim Lauffer, testified before another subcommittee last week that his suburban bank's loan-to-deposit ratio would increase from 49% to 67%.

That would actually understate many banks' support for community lending if they originate and sell a substantial amount of home loans each year. Most of the funds they lend originate in any given year will remain outstanding while they continue to originate and sell new loans the next. By using the secondary market this way we can leverage our deposits and provide an ever-increasing amount of long-term financing to homeowners throughout our community.

The term "deposit" also presents difficulties, particularly for community banks which depend much more heavily than large banks on deposits to fund their assets. In addition, public deposits can be a significant portion of a bank's deposit base, yet they are often short term. They are often placed in the bank for short periods. In short, they are not "core" deposits available for community lending. Including public deposits in the loan-to-deposit ratio would further misrepresent banks' lending activity.

Because of these factors, half of the banks under $250 million in assets do not meet the 60% requirement. Indeed, the regulators have said they chose that figure because it is the median. Because it is a national median, it does not take regional and local economic differences into account or the differences between rural and urban banks.

Hundreds of banks that are relatively close to the 60% ratio may try to book enough loans to reach a ratio which is inconsistent with safety and soundness. Thus, the proposed CRA regulation could become an artificial incentive to "reach" to make loans that a bank should not make. This could undermine the efforts of safety-and-soundness examiners who have for decades cautioned community banks against maintaining a too-high loan-to-deposit ratio.

This sort of artificial incentive is not only unwise, it is unnecessary. Many bankers have told me that they wish that there were more opportunities to make sound loans in their markets.

Because of these factors, we will recommend to the regulatory agencies that they drop any reference to a specific loan-to-deposit ratio.

Level of Banks Eligible for Streamlined Examinations

Though some have argued that the $250 million asset level encompasses too many institutions, it only applies to approximately 16% of the banking industry's total assets. There are many community banks above that level that operate with small staffs and with an intense local focus. They too should be examined under the streamlined examination system. Therefor, we are recommending that the regulators give community banks up to $500 million in assets the option of being examined under the tiered system. Even this level of coverage would increase the level of assets covered to approximately 19%.

We also recommend that banks under $250 million in assets within somewhat larger holding companies be eligible for streamlined examinations. Many of these smaller banks are operated as completely independent entities in widely separate markets and do not have any greater resources than banks outside of holding companies.

We strongly urge the regulators to provide for regular adjustments to whatever asset cutoff they adopt for the tiered system. This is needed to account for the fact that banks grow as a result of inflation, economic activity, and interest credited while maintaining the same level of staffing. A static asset level for streamlined examinations could discourage community banks from growing and helping their communities create jobs.

Enforcement Provisions

Under the proposal, regulators could impose the full range of enforcement provisions to enforce CRA. Congress did not provide for this when it originally passed CRA. It only provided that an institution's CRA performance would be a factor when an agency considered an application for approval of a new branch, a merger, or the like. We will urge the regulators to continue their current practice of enforcing CRA through the applications process.

LARGER BANK EXAMINATION SYSTEM

Service Areas

Our members -- which are fully examined for CRA compliance -- must often compete against branches of larger banks that are almost never visited by a CRA examiner. These branches are free to accept deposits and do little else to serve their community. The large bank may use some of the deposits to make splashy, but relatively small, CRA commitments in far-away communities. Otherwise, these branches get a free ride.

The proposed regulations begin to address this loophole. They would define a bank's service areas as those areas where it makes most of its direct loans. Even so, you should understand that the agencies lack the resources to examine all branches of large banks. They will have to rely on sampling. The competitive inequity will remain, though it might be somewhat decreased.

Other Financial Service Providers

At the time Congress passed the Community Reinvestment Act, banks and savings and loans played much larger roles in the financial marketplace than they do today. The cost of federal deposit insurance was comparatively low. Only commercial banks had direct access to the Federal Reserve's discount window. This has all changed.

Banks and thrifts have lost significant market share to competitors. The cost of federal deposit insurance has nearly tripled since 1989. In 1991 Congress gave securities firms direct access to the discount window. But, CRA still applies only to banks and savings and loans.

Non-bank institutions such as mutual funds, insurance companies, and credit unions benefit significantly from the Federal Government's commitment to maintain the stability of the financial system. However, the government imposes no community investment requirements on them. Given the shifts in market share from banks and savings and loans to these other financial players, a smaller and smaller share of the financial marketplace is under any CRA obligations. Banks and thrifts cannot singlehandedly cure the problems CRA was designed to address. We recommend that Congress expand CRA to encompass those firms that are gaining a greater share of the financial marketplace.

CONCLUSION

We appreciate this opportunity to assist you in your review of the proposed CRA regulations. We strongly urge you to support the tiered examination system that the regulators have developed for community banks. Unless community banks can get a break from the current heavy burden they will find it increasingly difficult to continue serving their communities. That would truly undermine the goals of the Community Reinvestment Act.

Center for Community Change

Testimony By

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Center for Community Change

Washington, D.C.

on

The Administration's Community Reinvestment Act
Reform Proposal

before

the Subcommittee on Consumer Credit and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

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Good morning, Mr. Chairman and members of the Subcommittee. My name is Allen J. Fishbein and I am the General Counsel of the Center for Community Change (CCC) and Director of the Center's Neighborhood Revitalization Project. My involvement in the community reinvestment field spans over sixteen years, during which time I have authored and co-authored numerous publications on the community reinvestment. In addition, I have served on the Federal Reserve Board's Consumer Advisory Council, the Federal National Mortgage Association's Affordable Housing Impact Advisory Council, and the American Bar Association's Consumer Financial Services Committee.

CCC is a national, non-for-profit organization, based here in Washington, D.C., that provides research and assistance to community groups working in low income and minority communities across the country. Over the course of more than twenty years, CCC has trained hundreds of grassroots organizations on the techniques for assessing community credit needs, evaluating lender performance, and building effective community reinvestment partnerships. In addition, we monitor the performance of the bank supervisory agencies in carrying out their mandates under the Community Reinvestment Act (CRA), Home Mortgage Disclosure Act (HMDA), and the fair lending laws. CCC is also a founding member and serves on the Board of the National Community Reinvestment Coalition, whose members are engaged in efforts nationwide to expand access to credit for low income and minority communities.

Chairman Kennedy, I very much appreciate the opportunity to testify here today before this Subcommittee on the important and timely subject of the Administration's CRA reform proposal. Your outstanding leadership and tireless support for expanding credit access in underserved communities has been invaluable in promoting much of the progress that has occurred in this area in recent years.

Last July, President Clinton directed the four federal regulatory agencies to undertake an effort to strengthen CRA enforcement by placing greater emphasis on the lending performance of financial institutions. The President's initiative was generally applauded by community groups and lenders alike as a means for improving administration of the act, which as we should all know by know has been plagued from the outset by weak and inconsistent enforcement. The Administration's proposal was finally unveiled at the end of last year.

We are certainly appreciative of the efforts by Comptroller Ludwig, who has served as the President's quarterback for this reform initiative. The energy and refreshing openness Mr. Ludwig brought to this endeavor has gone a long way toward restoring some measure of community group confidence in the commitment of the regulatory agencies to enforce CRA.

Despite the history of lackluster enforcement, CRA cannot be described as a failure. The law has been responsible for generating billions of dollars in new loans and investments to underserved communities. Further, the mere existence of CRA has spurred many banks and thrift institutions to discover new markets and develop new products to better serve the loan needs of modest income families and neighborhoods. In short, lenders and communities have found ways to form reinvestment partnerships to address unmet credit needs notwithstanding the many shortcomings which have existed in enforcement.

In testimony last fall before Congress on the then yet to be released reform proposal, Comptroller Ludwig stated, "One of the principal goals of the President's reform initiative is to achieve a CRA rating system that commands respect from all parties." We could not agree more with this statement. Inflated and inconsistent CRA ratings have been cited in a number of congressional inquiries as undermining the effectiveness of the statute.

As we know, Mr. Chairman, prior to the public disclosure of CRA ratings, which you championed, hardly any institutions examined received less than satisfactory CRA grades from the regulators. In contrast, in the first two and one-half years following the institution of the public disclosure requirement the distribution of CRA ratings changed considerably, with approximately eleven percent (11%) of industry receiving less than favorable ratings. There is evidence, however, that over the course of the past year ratings inflation in creeping back into the system. A study my organization is about to release found that the percentage of institutions receiving less than satisfactory ratings is down significantly. In first nine months of 1993 fewer than seven percent (7%) of lenders received less than satisfactory CRA ratings from their regulators.

Now clearly, this can be a case of whether the glass is considered to be half-empty or half-full. I guess an argument can be made that the decrease in poor ratings reflects improvements in the community reinvestment performance of lenders. Alternatively, it may simply mean that lenders are becoming more adept at working the system by providing examiners with what they think the examiners would like to hear. Based on my review of hundreds of performance evaluations I have read I think it is most likely to be the latter rather than the former.

In any event, I cite this information because it illustrates the ongoing need for clearer, more measurable performance standards, which we all know do not exist under the current regulatory scheme. In fact, we believe that the two most important measures for assessing the quality of the CRA reform proposal are: 1) Is it likely to lead to a ratings system "that commands respect from all parties"? 2) Is it likely to result in increased community reinvestment in underserved communities? Unless both questions can be answered in the affirmative, the exercise is little more than rearranging the furniture in the regulatory living room.

The Proposed System

The system the regulators are proposing is a far reaching one. It would completely scrap the old CRA regulations, with the twelve assessment factors that agency examiners have used for over fifteen years to assess individual lender performance. Instead, the type of examination that banks and thrifts would undergo would likely depend on their size.

Thus, under the proposed system financial institutions with assets under $250 million would be presumed to have a satisfactory performance under CRA if they passed on a number of screening criteria. Primary among these is the bank's loan to deposit ratio, with a 60% loan to deposit ratio presumed to be reasonable. Larger banks and thrifts would be subject to three tests, which would focus on their lending performance, their investments and their provision of banking services. Retail institutions would be judged primarily on the results of their lending test, while wholesale and special purpose banks' ratings would be determined by how they fared under the investment test.

"Pros and Cons" of the Proposed New CRA Regs

To begin with, we believe the regulators collectively deserve credit for proposing a thoughtful alternative to the current ineffective ratings system. For one thing, the proposal has required four to six weeks of study before anyone has been able to begin hurling grenades at it.

The proposed regulations seek to place greater weight on a lending institution's actual record of performance (i.e., loans made in low and moderate income areas) and much less emphasis on the process the lender goes through to achieve its record. We believe the proposal establishes a framework for shifting the emphasis of CRA enforcement to a more performance driven system, although considerable discretion remains with the examiners to interpret standards. While we like to the movement to a performance driven system, unfortunately, the proposed rules do not effectively address a number of important concerns. Moreover, in several key respects, we fear these regs could result in weaker, not stronger CRA enforcement.

Having said that, let me emphasize that we believe that the flaws in the proposal are certainly correctable through the administrative rulemaking process. Therefore, Mr. Chairman, we would encourage Congress to wait until the rulemaking has run its full course before making a judgment about whether legislative action is needed.

Important Steps Forward

As we talk to community groups around the country, consensus seems to be emerging around several elements of the proposal that groups feel represent significant advances over the status quo. These include:

1. Expanded disclosure of loan data.

The public disclosure of loan information has proven time and again to be a powerful tool for changing banking industry practices with respect to low and moderate households and communities. Under the proposal, new geo-coded information about small business, small farm, and certain types of consumer lending activities of larger banks (assets over $250 million) for the first time will provide the public with important information about where lending occurs. This information, along with housing-related disclosures, will be extended to rural areas for which there currently is no Home Mortgage Disclosure Act (HMDA) data. Moreover, the collection and disclosure of this data is integral to the implementation of a more performance oriented ratings system.

2. Use of supervisory powers.

The new rules spell out the circumstances in which the agencies can use their full range of supervisory powers (e.g., civil money penalties, cease and desist orders, etc.) against lenders that thumb their noses at CRA compliance. Under the proposal, those institutions receiving "Substantial non-compliance" ratings may be subject to enforcement actions. Additionally, if a lender receives a "Needs to improve" rating for three consecutive evaluations it will be automatically downgraded to "Substantial non-compliance." This provision is consistent with the statute, which gave the agencies broad discretionary authority to "implement the purposes" of the act.

3. Comparative market share analysis.

Under the reform proposal, the level of lending would primarily determine a larger retail bank's CRA rating. Lenders would be rated on the extent to which its share of various types of loans -- housing, small business, consumer, and small farm -- made in low and moderate income areas of its community compares, favorably or unfavorably, to its share of loans in the other areas of its community. In addition to this comparative test, the even distribution of a lender's loans throughout the low and moderate income areas of its community and the total amount also would be considered.

The market share analysis is central to creating a performance oriented rating institution. Under this method banks will be rated on whether they are as aggressive

in their efforts to do business in low and moderate income areas within their lending territories as they are in more affluent areas.

Although supportive of the market share approach, we recognize that certain aspects of this methodology need refinement. These concerns will be discussed later on in my testimony.

4. "Low income" and "moderate income" defined.

The regulations define low and moderate income for the purposes of CRA compliance. For the first time lenders, examiners, community groups and localities can all be sure that they mean the same things by these terms. We also like the proposed regs focus on serving low and moderate income needs as a cornerstone of the evaluation process.

Under the proposal, low income areas are defined as areas where the median family income is less than 50% of the median family income for the Metropolitan Statistical Area. In non-metro areas, its would be less than 50% of the non-metropolitan state-wide median family income for the state. Moderate income areas are those where the median family income is between 50% and 80% of the median family income for the MSA, or between 50% and 80% of the non-metro state-wide median family income for areas outside MSAs.

5. Advance notice of CRA exams.

The proposal gives the public advanced notice of the institutions that will be examined by the agencies and invites their comments. This would represent a considerable improvement over current procedures in which the public is largely kept in the dark about which lenders are scheduled to be examined for CRA purposes.

Critical Concerns

Opinion among community groups also seems to be converging on a number of aspects of the proposal that give rise to serious concern. These include:

1. The composite ratings place too much emphasis on activities other than direct lending.

Although the lending institution is intended to form the base line rating for larger retail banks, the proposal permits examiners to shift the rating, mostly upward, based on other investments made in, and services provided to, low and moderate income areas. Thus, investments would include donations or other forms of financial support to things like loan consortia, minority and women-owned businesses,

community development financial institutions, purchase of mortgage revenue honds. The weight these investment would be given would be based upon percentage it represented of the institution's risk-based capital. Credit also would be given for deposit services that are useful in low income communities, services and products that promote credit availability, and in part, based on how many of the institution's branches are located in or accessible to low and moderate income areas.

Unfortunately, the rule permits a lender with a less than satisfactory grade on its lending test to receive a "Satisfactory" or even "Outstanding" rating if its scores well on the investment and/or service tests. This proposal raises concerns for several reasons: 1) Allowing lenders to purchase a satisfactory rating via the investment test may discourage institutions from undertaking these activities on their own, which means that they will not develop the expertise or the products necessary for effect effective community lending which lies at the heart of CRA; 2) lenders may be able to devote fewer dollars to achieve a higher rating through the investment test than they would be required to do to achieve a comparable rating through the lending test; 3) institutions will be given credit for investments even though much of their benefit may be to entities located outside of their market areas, thus breaking down the traditional link between CRA and requiring lenders to serve local markets.

In order to correct this bounce, we recommend that the final rules require lenders to achieve at least a minimum "Satisfactory" grade in the base lending test in order to be eligible to receive "extra credits" via the investment and services tests.

2. Small bank exemption.

Although the agencies may call it "streamlined" procedures, the proposal effectively exempts small lenders (assets under $250 million) from the performance-oriented requirements that will apply to large lenders (i.e., regulators will not apply the numeric tests and the requirements to disclose additional lending data). As a result, 74% of banks and savings institutions will be exempt from the new record keeping requirements, although evidence shows some small lenders have some of the worse CRA lending records.

The proposed regs are constructed in a way that presumes small banks will receive a "Satisfactory" rating providing they meet six minimal threshold requirements, including an adequate loan to deposit ratio (60% is the general measure), a majority of their loans in its service area, an adequate loan mix by income category, no record of discrimination, no <u>bona fide</u> community complaints, and for HMDA reporters, an adequate distribution of housing related loans.

While perhaps a case can be made for the need for the regulators to tailor specialized examination procedures for smaller institutions, this proposal goes well beyond that. It seeks to fashion different ratings standards, which the CRA statute

clearly does not authorize. In fact, in 1991 Congress rejected efforts to exempt small banks from CRA coverage.

What we are the most concerned with is that this small bank exemption effectively places the burden on the underserved residents of non-metropolitan communities to rebut the presumption that small banks are satisfactorily serving their local communities. Unfortunately, this constituency is often least able to raise the type of bona fide complaints that will be required by the regulators. What is more, in many rural communities organized community groups do not even exist.

The small bank exemption should be eliminated and these institutions should be required to meet the same types of performance oriented tests that larger banks would be required to meet.

3. Backdoor safe harbor.

An implicit "safe harbor" is provided in the rules for lenders achieving an "Outstanding" or "Satisfactory" CRA rating. The proposal discourages public comment on corporate expansion requests for lenders with high CRA ratings, even though the ratings still rely to a large extent on the subjective judgment of examiners.

We believe that references to how CRA ratings will be treated as part of agency review of expansion requests should be deleted from the proposal. The Administration should develop a separate policy document addressing a whole range of matters concerning how community group challenges will be taken into account into the corporate expansion review process.

4. Role of discrimination in CRA evaluation is sharply curtailed.

If the proposal is adopted, examiner leeway is reduced for citing lenders for engaging in racial rediining or policies and practices that may have an adverse impact on minority applicants.

Under the existing regulations, examiners can cite "evidence of discriminatory credit practices or other illegal credit practices," and consider whether the lender was discouraging applications, or engaged in pre-screening. For example, examiners can now consider as part of the CRA examination whether the volume of applications from minority areas is significantly low, or whether there are differences in lending between low and moderate white and low and moderate income non-white areas. Under the proposed system, it is unlikely that they will be able to consider these matters unless they involve an actual case of lending discrimination that is underway.

We like the fact that the proposed rule would result in a less than satisfactory rating being assigned to a lender engaged in discrimination. At the same time, we

recommend that the proposal be modified to maintain the existing standard for considering "evidence of discrimination" in the CRA evaluation process.

5. No racial/ethnic data for small business loans.

Evidence suggests that lending discrimination against minority firms may be a severe problem. Yet, as a result of opposition from the Federal Reserve Board, the proposal does not require lenders to collect information on the race and ethnicity of small business borrowers that would be invaluable for detecting discrimination, much the same way that HMDA data has been useful in helping to identify mortgage discrimination.

Apparently, the inclusion of race/ethnic data on loan applications would require a modification to Reg B (Equal Credit Opportunity Act). Since the Federal Reserve Board has rulewriting authority under ECOA, a statutory change may be necessary before this important data is required to be reported.

6. Insufficient guidance is provided to examiners on the importance of different types of lending to individual market areas.

The proposed rule is incomplete in instructing examiners on how to weigh lending activities that meet the most pressing or difficult needs of low income communities and households. The "degree of difficulty" in providing certain types of important community development or community support loans should be better factored into the evaluation process. So should lending in low income household (income under 50% of area median income) as compared to moderate income households (income under 80% of area median income). Further, lending activities that promote "gentrification" and the displacement of low and moderate income residents should lead to downgrading in CRA evaluations, as required under the existing agency examination procedures.

We recommend that more detailed rules be set out in the final rule to provide sufficient and consistent guidance to examiners on how to weigh that are especially important to low and moderate income areas and households.

7. "Indirect lending"

The regs allow a lenders to bump-up what otherwise would be their base rating on the lending test by getting credit for loans made to third parties in which the institution has invested, including entities that are not part of the same corporate structure (e.g., community development financial institutions, loan pools, consortia, etc.). Like the investment test, this undermines the thrust of CRA to encourage lenders to develop the necessary expertise and products to do business themselves in low and moderate income communities.

We recommend that indirect lending should not be counted under the lending test, but should be factored into the investment test.

8. Creation of a private appeals process for banks.

The regs provide the opportunity for banks to rebut examiner findings and argue for higher grades that the performance tests would suggest. This appeals process would occur entirely behind closed doors, with no opportunity for the public to provide input or to make a case when they believe a lending's rating is too high.

We recommend that if a rating is challenged by a lender it ought to be published as a "proposed" rating and the community also be afforded an opportunity to weigh in with their comments about the appropriateness of the rating.

9. No needs assessment.

The existing system is criticized by some for directing examiners to place too much emphasis on steps taken by a lender to assess local credit needs. The new proposal would eliminate a needs assessment altogether. Yet, this is an important process for banks to undergo in order to understand how they can serve their local communities most pressing needs. It is also critical for examiners to have information on local credit needs, or they will have no context in which to evaluate lenders' performance.

We recommend that the regs require lenders to demonstrate that have taken steps to ascertain local community credit needs and to publish the information they have generated as a result of this analysis in their public file.

10. Strategic plans.

The proposal allows any lender to employ the option of creating a strategic plan that would include measurable goals for how the institution will meet local needs. Although there is mention that public comment on the adequacy of the plan in addressing local needs would need to be solicited, the rules set out surprisingly little detail about how this procedures would work. Further, it is very unclear as to the criteria the agencies would use for evaluating the proposed plan's effectiveness.

We recommend that the final rules provide at least 90 days for the community to review and comment on a lender's strategic plan. The agencies must also set out the criteria that will be used for determining the plans adequacy, as well as make a determination that the plan will not result in less activity than would otherwise be required under the three performance tests.

In conclusion, we believe the proposed CRA regulations offer great potential to establish a performance based evaluation system, but many issues must be resolved before we can say with any assurance that it will result in a ratings system that is likely "command respect from all parties," or one that is likely to result in increased lender activity in underserved communities.

This ends my formal testimony. I will be glad to answer any questions that members of this Subcommittee may have.

STATEMENT OF

JAMES M. CULBERSON, JR.

On Behalf of

THE AMERICAN BANKERS ASSOCIATION

Before the

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

February 8, 1994

Statement of James M. Culberson, Jr.
on Behalf of the American Bankers Association

Before the

Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance and Urban Affairs
United States House of Representatives

February 8, 1994

Mr. Chairman, I am James M. Culberson, Jr., Chairman of the First National Bank and Trust Company in Asheboro, North Carolina. I serve on the Board of Directors of the American Bankers Association, and I Co-Chair the ABA's Government Relations Council. The American Bankers Association is the national trade and professional association for America's commercial banks, from the smallest to the largest. ABA members hold about 90 percent of the industry's total assets. Approximately 94 percent of ABA members are community banks with less than $500 million in assets.

I am pleased to be here this morning to speak to the Subcommittee on the interagency proposal to overhaul the regualtory structure of the Community Reinvestment Act (CRA). I am very hopeful that this process of reexamining the current structure will result in a more workable and efficient system.

Few regulatory issues raise as much emotion as CRA. CRA began as a simple statement of community responsibility -- that each bank should meet the credit needs of its entire community, including low and moderate income neighborhoods. I am in complete agreement with this goal, as are virtually all bankers. The relationship between banks and their communities is, after all, a two-way street -- the profitability and strength of my bank rests squarely upon the economic health and vitality of my community, the individuals and local businesses that are my depositors and borrowers. I can assure you that anyone who does not understand this relationship won't last long in the business of banking.

The problem bankers have with CRA is not its philosophy, but its implementation. Over the years, as regulators struggled to find meaningful ways to judge compliance with CRA, it has simply grown into a monumental compliance nightmare.

The fact is that no one is satisfied with the current administration of CRA -- not bankers, not community groups, not regulators, and not Congress. In response to the growing level of dissatisfaction, the Administration directed the federal banking agencies to rethink the implementation of CRA. The agencies, in turn, have proposed sweeping changes in CRA's regulatory structure.

ABA's Government Relations Council will be meeting tomorrow and Thursday (February 9 and 10), and will devote considerable time to discussing the details of the proposal. Since the Council has not yet considered the proposal in depth, my statement today will deal with our initial reactions to the approach the regulators have taken rather than with many of the specifics of the proposal.

Mr. Chairman, we recognize that the regulators charged with redrafting CRA do not have an easy job. While the *intent* of CRA is clear and straightforward, designing an appropriate regulatory structure is anything *but* clear and straightforward, and it is admittedly difficult to satisfy all constituencies. How do you determine just how good a job a bank is doing in meeting the credit needs of its community without imposing huge reporting burdens and without substituting subjective regulatory decisions for private business decisions? How do you design a system that works for both very large and small banks? How do you design a system that works in urban, suburban and rural markets? How do you design a system that is efficient and does not allocate credit?

Another question of critical importance is at what point does the cost of compliance begin to constrain the ability of banks to meet community credit needs? Only a few short months ago, the Administration and many in Congress recognized that the excessive regulatory burden on the banking industry was one of the factors inhibiting the flow of credit to small businesses. Since documenting performance under the current CRA system is among the most costly and time-consuming regulatory burdens, it is vital that reform efforts look carefully at this issue, and that its importance not be underestimated.

Answering these and other fundamental questions on how CRA regulation should be redrafted is a challenging task. In order to help analyze the complex and lengthy proposal the regulators have put forth, ABA developed six principles. I would like to share these principles with the Subcommittee this morning.

The CRA system should:

- recognize differences in institutions and communities in the CRA process;

- improve the efficiency of the regulatory process by reducing the amount of required documentation and paperwork;

- provide realistic performance standards without credit allocation and without lowering credit underwriting standards;

- emphasize positive and achievable incentives to assist banks in making the extra efforts community development lending often requires;

- foster cooperation rather than confrontation between community groups and banks; and

- recognize the increasing role that financial service institutions not currently subject to CRA play in meeting the community credit needs.

How does the current proposal stack up against these principles? As you would expect, there is good news and bad news.

First the good news. The proposal takes a very positive step by recognizing that one size does *not* fit all. One of the biggest problems with the current system is that the same rules apply to large and small banks, to urban and rural banks, and to retail and wholesale banks.

Today's one-size-fits-all approach has been particularly hard on community banks because they have significantly less capacity to cope with the massive documentation requirements of the current system. Furthermore, the documentation requirements, often designed for urban areas, make no sense in small communities. So the concept of having a streamlined examination process for smaller banks is certainly going to be welcome news to community bankers. And because it frees up scarce resources for more productive uses in the community, it will be welcome news to bank customers as well.

Many bankers like the concept of a menu approach -- one that offers different options for demonstrating that they are meeting their community's credit needs. For example, the strategic plan option may be attractive to some larger banks. There are many large banks that already use a similar approach for their own internal goal setting and evaluation purposes. Other banks may prefer to use another option to show that they are meeting their CRA obligation.

The proposal also recognizes that certain specialized types of institutions -- like credit card banks and wholesale banks -- need to be able to meet their CRA obligations in a way that is compatible with their type of business, and, in the case of credit card banks, with the limitations on their charter. Rather than trying to make these institutions fit into the same regulatory mold as their full service retail-oriented brethren, the regulators' proposal offers specialized institutions alternative ways of satisfying CRA.

In summary, by recognizing the differences in banks and banking markets, this more flexible approach to CRA regulation conforms with the spirit of our first two principles. However, as is usually the case with complicated issues, the devil is in the details. We have great concern about many elements of the proposal -- not only about how they may be implemented in 1994, but also as to what they may evolve into in future years. We have seen well-intentioned laws and regulations turn into nightmares before. CRA is potentially so open-ended that our industry must be concerned about ever-increasing costs and its potential for slowly but surely substituting government and political control over the credit decision process.

For example, we have serious concerns about the proposal's new reporting requirement for all banks over $250 million in assets and all banks under a holding company structure that has aggregate bank and thrift assets of more than $250 million. This means that my bank, located in a rural/urban area with about $250 million in assets, would be subject to the same reporting requirements as huge banks with hundreds of billions of dollars in assets. Reporting institutions would be required to collect and report the geographic distribution of all small business, small farm, and certain consumer loans, including all written applications (approvals and denials); loans purchased; and indirect loans. In addition, some banks that are now not HMDA reporters would find themselves having to report home mortgage loans in this format as well.

The claim that reporting this data for small business/small farm loans would work just like HMDA reporting for home mortgage loans is simply not true -- small business/small farm loans are far more complex than mortgage loans. Home mortgages are relatively straightforward, homogeneous products -- small business and small farm loans are not. A loan on one house looks pretty much like a loan on any other house. But because no two small businesses/small farms are alike, these loans are individually tailored to suit each borrower's situation.

The standardization of mortgage lending, created largely by secondary market requirements, makes it relatively simple to design a standard application form requesting the pertinent information. The flexibility required by small business/small farm lending makes a standardized application form virtually useless for lenders. And this is why so many banks do not even use an application form for these loans -- at least not an application form that is in any way analogous to a residential mortgage loan application.

There is no doubt that the massive amount of new reporting required by the regulators' proposal would impose significant costs on both banks and their borrowers. The impact of this costly new burden should not be underestimated. The additional reporting will increase costs by slowing down the lending process and by requiring the collection of additional information from small business/small farm applicants, not to mention the additional compliance burden. And, because reporting is likely to lead to a standardized lending format, it may also reduce the flexibility that is such an important element of small business/small farm lending. In short, adding yet another expense to banks' lending activities will surely have a negative impact on both the cost and availability of bank credit.

Moreover, the data collected is not necessary to assess whether a bank is meeting its CRA obligations. Nor will the information collected tell you much about the credit conditions for small business, small farms or consumer borrowers. Banks are not the only source of these loans -- finance companies, credit unions, asset-based lenders and others do not report their lending activities. These are major players, and their omission will certainly give an incomplete picture of what is happening in these markets.

In summary, Mr. Chairman, I think it is pretty clear that the heavy new reporting requirements in the regulators' proposal fall far short of meeting the principle of improving

the efficiency of the regulatory process by reducing the amount of required documentation and paperwork.

The massive reporting requirements proposed for banks that do not qualify for the streamlined examination process highlights another issue of critical importance to community bankers -- the upper limit for the streamlined examination is simply too low and should be increased.

Mr. Chairman, as mentioned earlier, my bank has approximately $250 million in assets, so I feel I can speak to the ability of banks of this size to comply with the additional reporting that will be required for all banks that do not qualify for the streamlined exam. It will raise the cost of each and every small business, small farm and reportable consumer loan I make -- and it will hurt the very borrowers it is intended to help. All across the country, banks like mine are doing a good job in meeting the credit needs of their communities, and should have no trouble demonstrating that fact under a streamlined examination process. In terms of bank sizes today, $250 million in assets is small. To add this burden to a bank my size will do absolutely nothing to improve credit availability nor will it provide any meaningful information. To the contrary, it will add another costly and unnecessary regulatory burden with no or nominal benefit. The cut-off at $250 million should be raised.

The way the proposal is structured now, even the very smallest banks would not be eligible for the streamlined CRA examination process if they are part of a bank holding company with assets in excess of $250 million. CRA is a local issue -- and CRA compliance is done at the local bank level. It is not at all clear that a small bank in a large holding company has any more capacity to deal with the huge amount of paperwork and documentation than a small independent bank. If the goal of CRA reform is to improve credit availability to small businesses, small farms and consumers, I believe we must rethink the eligibility cut-off and put it on a *bank* basis, not a holding company basis.

We are also very concerned that the proposed 60 percent loan to deposit ratio test is unrealistic for many banks. For example, smaller community banks generally have a greater need for liquidity than do large banks, and may find a 60 percent ratio inconsistent with sound business practices. In fact, as bank size declines, so does the average loan to deposit

ratio. This makes the proposed 60 percent test regressive because the smallest banks are the least likely to have such a high loan to deposit ratio.

In addition, many market areas served by community banks simply do not have sufficient loan demand to generate a 60 percent loan to deposit ratio. This may be true, for example, in areas experiencing economic slowdowns, in areas with a high percentage of retired people, and in some rural areas where there is very little or no growth. The upshot is that for many community banks the 60 test is not a very good indication of how well they are meeting community credit needs.

In response to our concerns on this issue, the regulators have assured us that the 60 percent ratio is not intended to be a cut-off for passing or failing the streamlined examination. They indicated that the loan to deposit ratio need only be reasonable given the size, financial condition and market area conditions of the institution. While this clarification gives us some level of comfort, it does not put all our concerns to rest. The fact is that the proposed regulation sets the test at 60 percent, making it incumbent on each bank to prove why this is not a reasonable level for its particular circumstances.

Let me now turn to another issue of very great importance to bankers, and that is performance standards and credit allocation. Let me assure you that bankers are working hard to meet the credit needs of their communities. As I said at the outset of my statement this morning, they are doing so because the success of each bank is closely tied to the success of the community it serves. But we are growing increasingly concerned that the phrase "performance over paperwork" is being interpreted by some to mean that specific bank loan targets should be set for low- and moderate-income borrowers or for certain geographic areas. This is credit allocation pure and simple.

We are concerned that the "market share" test proposed by the regulators may have the unintended consequence of allocating credit. The market share test would compare a bank's lending share in low/moderate income areas with their lending share in other areas. If a bank wants to earn an outstanding rating, its market share in low/moderate income markets must exceed their share in other markets. In effect, then, the market share test will lead to credit allocation. And to the extent that banks are competing with each other to increase their market share in low/moderate income areas, there will be pressure to reduce their underwriting standards.

There is another dimension of this problem that may also have unintended consequences. Suppose, for example, that a minority bank has a 30 percent market share in a given low/moderate income census tract, with the remaining share divided among 4 other banks with a broader service area. If each of these 4 banks has a 25 percent market share in the surrounding area, to achieve a satisfactory CRA rating they would have to boost their market share in the low/moderate area from 15 percent to 25 percent. It puts extreme underwriting pressure and interest rate pressure on the minority bank in the heart of its own market. Where does this leave the minority bank?

Mr. Chairman, the term "credit allocation" has a negative connotation -- and with good reason. In this instance, it is particularly disturbing because it may well be inconsistent with safe and sound lending. This should concern not only bankers, but regulators, the Congress and the public as well. We ask that the credit allocation aspect of the regulators proposal be given very careful thought before potentially negative incentives are put in place.

Let me now turn to the principles of creating positive incentives and promoting cooperation rather than confrontation. Finding ways to satisfy these principles will provide a far more desirable way of encouraging banks to devote the extra time and money that is necessary to build a successful community development lending program. What encouragement is there in the regulators plan to put in extra time and money?

For that matter, what assurances are there that a strong and consistent record of CRA compliance will stop unsubstantiated challenges to applications for mergers? There is no regulatory benefit under the CRA process for meeting the credit needs of a bank's community. In fact, many bankers believe that earning an "outstanding" only serves to make the bank a magnet for criticism and demands for additional effort by the bank.

If positive encouragement cannot be provided for outstanding CRA performance, doesn't this perpetuate confrontation and eleventh hour challenges by community groups? Even for banks rated "satisfactory" or "outstanding", applications for an acquisition or a merger are often protested by advocacy groups seeking grants or loan commitments. A bank that is not deficient in meeting its community's credit needs deserves to be freed from costly delays arising from unsubstantiated challenges during CRA review.

The number of successful joint projects between banks, local governments, nonprofit organizations and community groups demonstrates that cooperation, rather than confrontation, yields far better results for all involved. There are many, many examples of bankers, community groups and local governments working together to solve local problems and to build a better future.

ABA's Center for Community Development was established in 1992 as an expression of the industry's commitment to help bankers improve and enlarge their community development lending programs. It also provides a vehicle through which banks can share their knowledge and expertise in the field not only with other lenders, but with community groups, secondary market agencies, mortgage insurers and other interested parties as well. Through the Center, we hope to be better able to build on the successful programs that are already on-going in large and small communities across the country.

Our last principle addresses the issue of reaching beyond the banking industry for investment capital. There are other financial intermediaries such as brokerage firms, mutual funds, money market funds, insurance companies, members of the Farm Credit System, and even credit unions, which offer bank-like products that draw savings and investment funds by the tens of billions of dollars out of communities across the country. But these institutions are not held to the same high standards of community responsibility that banks are. They have the ability to offer combinations of financial products and services that banks cannot offer which gives them a competitive edge; and yet, they are not required by laws or regulations to make any reinvestment in the communities from which they draw money. This situation makes it even more difficult for banks to carry virtually the whole load in meeting community credit needs. We realize that this issue is not under the purview of the banking regulators. Nonetheless, it is an issue that will become more and more important as financial markets continue to evolve.

I would like to add one final point on the issue of CRA that is of great concern to bankers, and that is the continued exclusion of credit unions from CRA. Even community development credit unions are not covered by CRA. The credit union industry often argues that it is so small in comparison with the banking industry that the differences in regulatory costs are unimportant. That is not true. Two of my biggest competitors are credit unions -- *both larger than my bank and federally insured* -- and yet they have no CRA responsibilities. Community banks that are working hard to meet their customers needs

while laboring under a heavy regulatory burden -- including CRA -- find it incredibly frustrating that their credit union competitors do not play by the same rules, nor do they face the same compliance costs. How can this be justified?

Conclusion

Mr. Chairman, a great many questions remain about how to construct the appropriate regulatory framework for CRA. My statement this morning looks at only a few of the important issues raised by the regulators' proposal.

There are, however, many questions about how the strategic plan option will work and whether it will prove to be an efficient, effective way to demonstrate CRA compliance or whether it will become encumbered by bureaucratic red tape and confrontation with community groups. There are also questions about how the market share component will work and whether it makes sense for any business to have market shares equivalent across all regions of a service area. There are questions about how and in what form the service and investment component will count for CRA compliance. There are questions about what the use of a fixed loan-to-deposit ratio in determining CRA performance in light of differences in bank size, liquidity needs, market area, and competition from depository and non-depository institutions.

Certainly, the proposal put forth by the bank regulators moves affirmatively to satisfy at least some of the important principles for CRA reform. However, many elements -- particularly the truckload of new reporting requirements for larger institutions -- are entirely at odds with efficient and effective CRA reform and, if approved, will continue to constrain available credit, particularly to those borrowers on the very edge of safe and sound underwriting standards. Such an important initiative requires very careful analysis to fully understand the ramifications. No matter how good the concept, inevitably the difference between improved efficiency and failure lies in the details -- which, as we all know, is where the Devil often lurks.

Testimony Submitted By

Bertha Lewis
New York ACORN

On Behalf Of
The Association of Community Organizations for Reform Now
(ACORN)

On
the New Community Reinvestment Act (CRA) Regulations

To
The Subcommittee on Consumer Credit and Insurance of the
Committee on Banking, Finance, and Urban Affairs
U.S. House of Representatives

The Honorable Joseph P. Kennedy, II, Chairman

February 8, 1994

Good Morning, Mr. Chairman and members of the Subcommittee. My name is Bertha Lewis, Director of New York ACORN. I appreciate this opportunity to testify before you today on behalf of ACORN.

ACORN

ACORN, the Association of Community Organizations for Reform Now, is the country's largest grassroots organization of low- and moderate-income families. ACORN consists of 400 neighborhood groups organized in 26 states that work on a broad range of issues, including neighborhood safety, affordable housing, and education reform.

ACORN was the first community group ever to file a Community Reinvestment Act challenge in 1978, and has worked closely with many lenders around the country to improve access to mortgage credit for low- and moderate-income and minority families.

ACORN's sister organization, the ACORN Housing Corporation, develops affordable single- and multi-family housing for low- and moderate-income families.

INTRODUCTION

The proposed CRA regulations issued in December by the four federal banking agencies represent a radical departure from present policy and practice. ACORN supported the President's stated goal of strengthening enforcement of CRA and focusing CRA evaluations on performance rather than process.

Unless the regulations are substantially strengthened, however, we believe that the proposed regulations will not meet the President's objectives, and may in fact result in less --not more-- credit availability in our communities.

Conversely, if the regulations are significantly strengthened, they can potentially result in new housing and employment opportunities for millions of low- and moderate-income families.

SUMMARY OF TESTIMONY

I have appended to our testimony ACORN's briefing paper on the regulations, *Analysis of the New Community Reinvestment Act Regulations,* which contains 16 specific recommendations for strengthening the regulations. The testimony below first summarizes the points made in that document, offers some observations on the politics of CRA reform, and discusses two new controversies --over the market share methodology and the "safe harbor" provision-- that have arisen since that time. Finally, I will briefly touch on what the appropriate role for the Congress might be.

My testimony today has three principal points:

1. Taken as a whole, the regulations proposed by the agencies --in their current form-- would not lead to increased community reinvestment in our neighborhoods. Unless they are significantly strengthened, they could result in decreased credit availability for underserved populations and sectors in many communities in the nation.

2. The regulations have many positive features, including:

a. the creation of a framework that, with modification, can provide the basis for a performance-oriented evaluation system;

b. a focus on the provision of credit in low- and moderate-income neighborhoods, including for the first time a definition of "low-income" and "moderate-income";

c. requirements for public disclosure by depository institutions with more than $250 million in assets of small business, small farm, and other lending on a census tract basis;

d. the use of a comparative market share methodology, which provides a sound basis for evaluating CRA performance;

e. the clarification of the agencies existing enforcement authority for institutions in non-compliance with the law, which includes the use of cease-and-desist orders, civil money penalties, and other actions.

3. The regulations also contain many negative features, which include:

a. the creation of a "two-tiered" system for the evaluation of small and large lenders that may effectively exempt small banks from CRA;

b. allowing lenders to count "indirect lending" by third parties, such as community development financial institutions, in which they have invested for purposes of the lending test;

c. allowing lenders that redline to achieve an overall rating of "satisfactory" or even "outstanding" by virtue of non-lending activities, such as investments;

d. the creation of a *de facto* safe harbor provision that would greatly undermine the weight given to public comment in the applications process;

e. a significantly lesser role for racial discrimination in the CRA evaluation process;

f. allowing lenders to receive CRA credit for loans that

result in gentrification or the displacement of low- and moderate-income households;

g. insufficient attention to the "degree of difficulty" of lending: loans in moderate-income and low-income areas would receive the same weight; complex loans for rehabilitation of multi-family housing would receive the same weight as consumer loans; and home improvement and refinancing loans would receive the same weight as single- and multi-family originations.

h. the creation of a behind-closed-doors appeals process for lenders dissatisfied with their CRA ratings ("rebuttable presumption");

i. insufficient clarity about how composite ratings would be arrived at in the case of lenders with multiple service areas;

j. failure to require the disclosure of the race and ethnicity of small business borrowers;

k. too much ambiguity in the service test, with respect to both the evaluation of branch locations and the definition of basic banking and government check cashing services;

l. credit given for activities that are of marginal benefit to communities, or which represent a minimal "stretch" for lenders, such as investments in mortgage revenue bonds;

m. the absence of a system for examiners to evaluate the the nature and extent of community credit needs, a necessary foundation for assessing bank performance under the CRA;

n. a lack of clarity about how strategic plans filed by lenders would be evaluated by the regulatory agencies, including the process by which community challenges to strategic plans would be handled; and

o. the absence of plans to train examiners in community lending, or to develop internal infrastructure at the agencies to deal with the new system.

OBSERVATIONS ON THE POLITICS OF CRA REFORM: A FAILURE OF LEADERSHIP?

ACORN was at first excited when the President included strengthening CRA in his campaign platform, and again when it appeared that his appointees were putting fair lending and community reinvestment on the front burner.

Unfortunately, while the Administration has taken a strong verbal stand for fair lending and community reinvestment, its actions have yet to adequately match these words. Indeed, to date, we have seen time and time again a lack of political will to take on

the banking industry when necessary to achieve stated policy goals. A few examples include:

*Despite the tough talk of the Administration on CRA reform, the distribution of CRA ratings under Clinton appointees has gotten worse More than 93% of CRA ratings are now "satisfactory" or better compared to 89% under Bush appointees I cannot believe that a single person in this room believes that 93% of the country's banks deserve passing CRA grades To paraphrase Senator William Proxmire how can so many of our banks be passing while so many of our neighborhoods are failing?

*Despite a pledge from the Comptroller of the Currency to launch a testing program for loan bias, this pilot project has been delayed, postponed, and put back on the shelf. And the other agencies have yet to take any action at all.

*While there have been a few more referrals to the Justice Department for violations of the fair lending laws, the change has been marginal at best --though there is now widespread acknowledgement that discrimination in the banking industry is pervasive.

*The agencies continue to take a narrow view of loan discrimination, focusing on disparate treatment of loan applicants, to the exclusion of issues of pre-screening and disparate effects.

*Despite the obvious implications for fair lending, community reinvestment and consumer compliance, the Administration's major banking initiatives --ranging from interstate branching to regulatory consolidation-- have contained virtually nothing for consumers or communities.

The approach of this Administration in this area has been to throw community, consumer, and civil rights groups the occassional bone, and to serve the banking industry filet minon One is tempted to wonder whether the occasional tough rhetoric about discrimination in lending coming from the Administration is designed to forestall opposition to serious initiatives to further the industry's deregulation agenda -regulatory relief interstate branching, bank sale of mutual funds and insurance, and the rest.

From the outset, the process by which the Administration has sought to reform the Community Reinvestment Act has been driven as much by politics as by substance. The Administration has sought to play a coy game of hide and seek with all interest groups --and has resisted tough choices.

A classic case of this problem is the treatment of small banks in the proposed regulations. We have yet to hear a substantive defense of this provision from anyone in the Administration. It is clear that the political calculus of constituency politics --the political power of small banks, and the lack of community

organization in many poor and minority communities in rural areas --rather than the actual record of small banks at meeting community credit needs that has shaped the contours of this proposal.

CRA reform is not rocket science. Ultimately, the consequences of this reform initiative for low- and moderate-income communities will depend on the political will of the Administration. Press reports of meetings between representatives of the banking industry and the regulatory agencies suggest that the agenies are in full retreat from many aspects of the proposal, including the loan-to-deposit ratio test for small banks. The record to date of political backbone at the agencies does not augur well for a genuinely progressive CRA.

Add to this lack of will by the Administration the bedrock opposition of the Federal Reserve and some parts of the banking industry, and we may have a recipe for backsliding and evasion -- in short, for a weaker, not a stronger CRA.

COMPARATIVE MARKET SHARE ANALYSIS

Most of the positive and negative features of the proposal are discussed at length in the attached analysis. I want to take some time to discuss one feature of the proposal that has come under heavy attack from the banking industry in recent weeks, namely the market share methodology that forms the basis of the lending test set forth in the proposed regulations.

The market share analysis forms the core of a performance-based system for evaluating CRA performance. Under this method, a bank's share of the market in home mortgage, small business, and consumer lending in low- and moderate-income areas will be compared to its penetration of the market in the rest of its service area.

While many details of the methodology require revisions, as discussed in the attached *Briefing Paper*, it is far preferable to a formula driven approach of the kind developed by the New York State Banking Department for at least three reasons:

1. It compares banks to themselves.

The market share analysis has the virtue of focusing and examiner's attention on whether an institution is as aggressive in seeking out business opportunities in the low- and moderate-income areas of its service area as it is in high income areas. A bank that has a much higher level of penetration in high-income areas than low- and moderate-income areas should --except in aberrant cases-- get a less than satisfactory rating. Needless to say, this methodology depends on the availability of geo-coded lending data for lenders' primary product lines (housing, small business, etc.).

Take as an example mortgage lending in Los Angeles in

1990. One thrift, Great Western Bank made 24% of all the mortgage loans in low- and moderate-income areas, and 9% in high-income areas. Bank of America, on the other hand, made only 3% of all the mortgages in low- and moderate-income areas, compared to 9% of all mortgages in high-income areas. Under the current system, both lenders got "outstanding" CRA ratings. Under the new system (assuming similar performance in small business and consumer lending), Great Western would probably get an "outstanding" CRA rating under the lending test, and Bank of America would get a less than satisfactory rating under the lending test. (Ironically, the proposed regulations would still allow Bank of America to get an overall rating of "satisfactory" or "outstanding," despite its record of redlining, by virtue of its record of investments and services.)

2. It compares banks to each other.

Implicitly, the market share analysis compares the performance of lenders to other lenders in the same market. Thus, a lender is not being evaluated in a vacuum, but in relation to the performance of other lenders.

It should be noted that the market share method will fail as an indicator of performance in areas where there is little or no lending in low- and moderate-income areas by all lenders. In such cases, a high market share in low- and moderate-income areas would mask the overall low level of lending. The proposal addresses this issue by requiring examiners to determine whether the overall level of lending in low- and moderate-income areas is "substantial," "significant," etc. Arguably, more guidance for examiners may be required in defining these terms.

3. If provides flexible, rather than arbitrary standards for evaluating performance.

Rather than setting an arbitrary numerical test for performance, the proposal acknowledges that community credit needs will change over time. For example, if the need for mortgages in low- and moderate-income neighborhoods increases over time, lenders in those areas will not be stuck at an arbitrary level of lending, but rather would be encouraged to respond aggressively to changes in market conditions.

The banking industry has raised three principal objections to the market share methodology, all of which appear to rest on the realization that many of the largest banks in the country with high CRA ratings might not fare so well under the new system. First, they argue that the market share test will result in numerous "anomalies," for example in areas where only there is only one large bank covered by the reporting requirements. Such a lender would, by definition, have a 100% market share throughout the service area. While there will certainly be anomalous cases, we believe the credibility of the rule should rest on the typical scenario, with many institutions reporting information to the

agencies. The rule provides ample flexibility to deal with the exceptional cases.

Second, bankers --and especially the Federal Reserve-- have argued that the rule might result in "gaming" of the system, i.e. underpricing of loan products to capture market share in low- and moderate-income areas. Frankly, we think that bringing the market and the forces of competition to bear in low-income areas is exactly what's needed. When lenders compete aggressively for business in high-income areas, this is usually called capitalism --the workings of a market economy. Such competition in low-income areas should be viewed in the same way --as providing benefits to banks and communities alike.

Third, trade groups have argued that the market share analysis might lead lenders to make unsafe or unsound loans. This argument has been brought to bear against CRA for many years, and has never been substantiated. A recent study by the Woodstock Institute suggests that single-family mortgages in low- and moderate-income areas have *lower* default rates than mortgages in middle- and high-income areas. Data collected by the Private Mortgage Insurance (PMI) industry confirms this finding. While lenders may have to *revise* underwriting standards to do more business in low- and moderate-income neighborhoods, such revisions have not in the past led to a decrease in credit quality, and there is no good reason to expect that changes in response to the nature of the market being served will do so in the future.

CLARIFICATION OF "SAFE HARBOR" PROVISION

One of the major flaws in the proposal is the portion of the regulation that appear to create an effective safe harbor for banks with satisfactory or outstanding CRA ratings. I would like to shed some light on this controversial portion of the regulation.

The OCC and Administration officials consistently deny that the regulations contain any safe harbor. They claim that the portion of the regulation dealing with applications is merely a codification of existing agency policy.

However, it is important to recognize that it is really the Federal Reserve which decides most major merger applications, because of its authority under the Bank Holding Company Act. Thus, the views of the other agencies on this aspect of the rule are virtually irrelevant. In the Federal Reserve Board's public discussion, Governor Larry Lindsey clearly stated that he believed that the provision would provide an "incentive" to banks for strong CRA compliance. He has subsequently added that he believed that it represented a mid-way point to a full safe harbor for banks with satisfactory or better ratings. Thus, the Fed believes that this provision constitutes a modified "safe harbor" --and it is the Fed's view that really counts in this area.

Even a modified "safe harbor" is a terrible idea, for many reasons. First, the new system will still rely to a large extent on subjective judgements by examiners --and examiners have often proved fallible in the past Second, the new evaluation scheme would require examiners to *sample* service areas for lenders operating in many cities and rural areas. A bank could get a satisfactory CRA rating by virtue of its performance in thesampled areas, but still be doing an inadequate job in non-sampled areas. Only the public comment process would bring such evidence to light Lastly the credibility of CRA ratings will be open to question for many years to come, and won't be known for certain until there are several years of experience with the new system.

We should note that the regulations do absolutely nothing to address one of the main problems with CRA identified by community groups over the years, namely the way in which the Fed s closed and secretive procedures effectively insulate banks from community group challenges. Under current practice, the Fed almost never holds public hearings or grants extensions of the public comment period, even when major interstate applications are protested by many community groups. At the same time, protests almost never result in the denial of merger applications, which sends a signal to the banking industry about the seriousness with which the Fed regards CRA.

In our view, either the agencies should address all the issues surrounding how applications are handled --including the lack of openness and credibility in administrative procedures-- or they should delete this section of the regulation altogether.

WHAT SHOULD THE CONGRESS DO?

ACORN would prefer that CRA be strengthened through the regulatory process. However, if the key problems raised by the proposed rule, and described at length in the attached briefing paper, are not resolved in the final rule, we will approach Congress with legislative proposals to undo any significant damage that may be incurred. Until the regulatory process runs its course, however, legislation in this area would be counterproductive.

In addition, the Administration is not completely beholden to the Federal Reserve Time and time again, the Fed has provided a convenient excuse for the weaknesses of the proposal. Yet, there is nothing to prevent the other three agencies from approving strong final regulations, even with the Fed's opposition. While it would be preferable for all the agencies to approve a strong CRA regulation if that proves impossible, Congress should insist that the other three agencies proceed with a progressive new regulation rather than further weaken the proposal to accomodate the Federal Reserve.

CONCLUSION

Again, Mr. Chairman and members of the Subcommittee, I cannot

emphasize enough how important CRA is to our communities. It has already resulted in billions of dollars in loans for housing, jobs, and community development that have would otherwise have not been made.

In New York alone, I have witnessed a revolution in the practices of the industry with regard to home mortgage lending, resulting in unprecedented opportunities for credit access and economic opportunity for thousands of low- and moderate-income and minority families.

It is crucial, therefore, that the new regulations build on the strengths of the existing system. We hope that many of you will urge the agencies to significantly strengthen the regulation, as discussed in the attached briefing paper.

We believe that these oversight hearings will contribute to a stronger and more effective CRA.

Thank you, Mr. Chairman, that concludes my statement.

ANALYSIS OF THE NEW COMMUNITY REINVESTMENT ACT (CRA) REGULATIONS

BRIEFING PAPER

January 1994

by

ACORN

Association of Community Organizations for Reform Now

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Briefing Paper

ACORN

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Background & Overview

The four federal banking agencies proposed new regulations to implement the Community Reinvestment Act (CRA) on December 22nd. Public comments on the proposed rule, which would replace the existing regulations in their entirety, are due by February 22nd.

The agencies issued the new rules in response to a request by the President that they revise the regulations to emphasize lending performance over process and documentation, and strengthen enforcement of the law.

The sweeping and dramatic changes proposed by the new regulation raise many serious concerns. Whether or not the new rules will meet the President's objective of increasing credit availability in low- and moderate-income neighborhoods will largely depend on the resolution of many key issues discussed in this paper.

Unless the proposal is considerably strengthened, the impact of the proposal on many low- and moderate-income communities may be neutral or even detrimental.

The new rules raise a wide variety of technical and practical issues regarding implementation. For the most part, this paper focuses on structural and conceptual issues raised by the rule. Technical issues will be discussed in ACORN's formal comment on the regulation.

The briefing paper first provides a summary of the key features of the proposed regulations, and proceeds to an analysis of major issue areas. The order of subjects discussed in the paper generally follows the logic of the proposed regulations. An overall assessment of the regulations is provided in the conclusion.

Summary of the Proposal

Two-tiered system

The current CRA regulations consist of 12 assessment factors. The new rules would replace the existing factors in their entirety, and establish a "two-tiered" system of evaluation for lenders with less than $250 million and more than $250 million in assets.

Treatment of small banks and thrifts

Small banks and thifts --defined as independent banks or thrifts with less than $250 million in assets or banks and thrifts owned by holding companies whose total banking assets are less than $250 million-- would be subject to minimal, "streamlined" requirements. A lender would get a "satisfactory" rating if it passed the following six tests:

1. a "reasonable" loan-to-deposit ratio (60% is presumed to be reasonable);
2. makes the majority of its loans within its service area;
3. has a "good loan mix" --a variety of loans made available across income levels;
4. has no "bona fide" complaints from community members;
5. has not engaged in discrimination; and
6. for a bank reporting under HMDA (banks in urban areas with more than $10 million in assets), a reasonable geographic distribution of loans.

Small banks passing all six tests would receive a "satisfactory" rating, while lenders not passing any one of the tests would undergo a more thorough examination. Under the $250 million threshold, 74% of all banks and thrifts would undergo the "streamlined exam."

Two Options for Large Lenders: Strategic Plan and Lending, Service, and Investment Tests

Lenders with more than $250 million in assets could choose to be evaluated under one of two assessment schemes. They could choose to develop a "strategic plan" with measurable goals, have the plan approved by their regulator, and be evaluated on the basis of their performance with respect to the goals outlined in their plan. Lenders not choosing the strategic plan option would be rated under lending, service, and investment tests on a five-point scale. These three ratings would then be used to arrive at a composite rating which would be on the four point scale mandated by statute. (Wholesale and special purpose lenders would not be evaluated under the lending test. Instead, their performance under the

investment and service test would determine their rating.)

Lending Test

The heart of the lending test is a comparison of the market share of institutions in low- and moderate-income neighborhoods to their market share in the rest of their service area, separately analyzed for home mortgage, small business, and some consumer loans. The market share analysis effectively compares an institution to itself --whether it is equally aggressive in seeking out lending opportunities throughout its service area-- and, implicitly, compares institutions to others lenders in the service area.

In general, lenders whose share of the market in low- and moderate-income neighborhoods is "roughly comparable" to their market share in the rest of their service area would get a "satisfactory" rating, while lenders whose market share in low- and moderate-income areas exceeded their share in affluent areas would get an "outstanding" rating. Conversely, lenders with a market share that was "less than, and not roughly comparable to" their market share in high-income areas would get less than satisfactory ratings.

Lenders could choose to count "indirect lending" for purposes of the market share analysis --i.e. lending done by affiliates of the bank or community development banks in which the lender had made an equity investment.

After computing the market share figures, examiners will check the actual number of loans originated in low- and moderate-income areas. This provision is designed to deal with cases where an institution may have a high market share in low- and moderate-income areas, but because the level of lending by all lenders is very low, the market share may not indicate a good performance.

Service and Investment Tests

The service test focuses on the percentage of branches accessible to low- and moderate-income neighborhoods, with consideration given to the provision of basic banking, government check cashing, and other services. For retail lenders, the examiners will analyze the percentage of branches that are in or accessible to low- and moderate-income neighborhoods and make a judgement as to whether this percentge is "substantial," "significant," etc.

The investment test measures investments by institutions in specified activities that benefit low- and moderate-income neighborhoods relative to their risk-based capital. Examples of qualifying investments include investments in loan consortia, minority- and women-owned banks, community development financial

institutions, or mortgage revenue bonds, provided that they benefit low- and moderate-income areas (a retail bank would get credit for all of its qualifying investments, provided that a portion benefited its service area).

Adjustments and Rebuttable Presumption

Under each of the three tests, a lender's rating could be adjusted upwards to reflect qualitative aspects of their performance, such as the degree of difficulty or innovation of the lending and investments undertaken by institutions. Only in exceptional cases would an institution's rating be downgraded --if the lender believed that the quantitative analysis did not accurately reflect the lender's actual performance in low- and moderate-income neighborhoods.

After an examiner arrived at preliminary ratings under each of the three tests, a bank would have the opportunity to "rebut" the rating, either because the analysis failed to take into account certain aspects of its performance, or because of peculiarities in its service area.

Composite Ratings

For retail institutions, the rating under the lending test would form the "base" rating. An outstanding rating under the service test could increase a lender's grade one level, while a rating of substantial non-compliance could decrease the rating one level. An outstanding or "high satisfactory" rating under the investment test could increase a lender's rating two or one levels, respectively. A lender's rating could not be reduced by virtue of its performance under the investment test.

Lenders with multiple service areas within a state would be rated separately for each service area and a single composite rating for the whole state would then be determined. The rule does not specify how disparate performance by a lender in different service areas would be reconciled.

Disclosure of Loan Information: Small Business and Consumer Lending

Lenders with more than $250 million in assets would be required to report and publicly disclose their small business and consumer lending on a geographic basis. Data would be reported on originations, applications, denials, and purchases of loans. There would be five categories for small business loans, based on the annual sales of the small business, and the number of employees. Lenders would report data only on closed-end consumer loans, and would not have to report data on credit card or automobile loans. Data would not be collected on the race, gender, or income of borrowers or applicants. All the loan data would be

collected in both urban and rural areas, by census tracts or block numbering areas.

Enforcement

The rule would for the first time clarify that institutions in substantial non -compliance would be subject to the full range of enforcement powers available to the agencies --including civil money penalties and cease-and-desist orders. Institutions receiving a "needs-to-improve" rating on three sequential exams would automatically get a rating of "substantial non-compliance" after the third exam. Previously, a low CRA rating was a factor only for lenders that had corporate applications --to merge or open new branches, for example-- pending before a regulatory agency.

De Facto "Safe Harbor" Provision

The rule appears to create a *de facto* safe harbor for lenders with "satisfactory" or "outstanding" CRA ratings. In order to provide an "incentive" to institutions, the regulations "clarify" how the agenices will deal with applications to merge or expand based on CRA ratings (the previous regulations were silent on applications procedures).

Discrimination

Institutions that have engaged in discrimination could not get a satisfactory rating, although the evidentiary standard for discrimination is significantly higher than it was under the previous regulations.

Public Comment Prior to CRA Exams

The public would for the first time have the ability to comment on lender performance *prior* to CRA exams (a listing of banks to be examiued would be published 30 days in advance of the calendar quarter).

Delineation of Service Areas

The new rules require lenders to delineate their service areas by defining their "effective lending territory" except that the service area could not arbitrarily exclude low- and moderate-income areas. Lenders operating throughout a state would have to define separate service areas for each MSA and rural area in which they originated loans.

Definition of Low- and Moderate-Income Neighborhoods

"Low- and moderate-income neighborhoods" would for the first time be defined as neighborhoods where the income is less than 50% or 80%, respectively, of area median income (AMI).

1. Treatment of Small Banks and Thrifts

The proposed rule would establish a lower set of compliance standards for lenders with less than $250 million in assets --approximately 72% of the banks and thrifts in the country. Lenders with less than $250 million in assets would simply have to meet six tests in order to get a satisfactory CRA rating, including an adequate loan-to-deposit ratio (of not less than 60%), a majority of loans in its service area, its record of discrimination and of community complaints, an adequate "loan mix," and, for HMDA reporters, a reasonable geographic distribution of mortgage loans.

Beyond the technical difficulties it presents, the small bank provision in the proposed rule represents a major retreat from current policy and practice, and may in effect amount to an exemption for small institutions. This retreat is justified neither by legislative history, nor by the performance of small banks.

Nowhere in the statute is there any indication that Congress intended small banks to be held to a lower standard than larger banks. Indeed, proposals to exempt small banks and thrifts from CRA have been soundly defeated in the Congress, as have efforts to raise the threshold for institutions required to report under HMDA from $10 million to $50 million.

Moreover, there is no evidence that small banks are better performers under CRA than their larger counterparts. Small banks have accounted for a disproportionate share of the lowest CRA ratings awarded since 1990, and anecdotal evidence strongly suggests that these institutions are actually less responsive to the needs of low- and moderate-income people than their larger counterparts.

Proponents of relaxed treatment for small banks argue that different standards are justified by the disproportionate burdens that CRA places on small banks. In fact, CRA imposes only 3 minimal technical requirements on lenders: posting a notice in the lobby of a branch, maintaining a public comment file, and preparing a CRA statement containing a map of the lender's service area and a list of products offered. Agency policy is that institutions need not maintain any additional documentation beyond that kept in the ordinary course of doing business. In addition, the existing regulations and policy guidelines direct examiners to take the size and capacity of institutions into account in assessing compliance. While individual examiners may have departed from this policy, this argues for better training --not lowered standards.

Residents of rural areas will be especially hard hit by the rule, since they are

disproportionately served by small banks, and often have few banking options. Many of the rural communities in which many small banks operate are ethnically and racially diverse, and contain large low- and moderate-income populations. Rural areas are, compared to major urban centers, without community or "watchdog" organizations and are therefore particularly dependent on effective supervision. Indeed, the argument that small banks "by their nature" serve their communities misses the mark --rural communities are often not homogenous, and a small bank is as likely to avoid certain areas or populations as large institutions.

With the exception of the loan-to-deposit test, the specific threshold standards established for smaller institutions are either too low or too vague to be meaningful.

For example, it is altogether unclear how lenders, examiners, or the public can know whether an institution makes the majority of its loans within its service area, or whether it has a "good loan mix" including a distribution across income levels, without any collection of data. Beyond the practical question of implemetation, the rule leaves unclear what constitutes a "good loan mix" and does not indicate whether or how examiners would be required to justify their conclusions in the public CRA evaluations.

The "discrimination" and "community complaint" tests may prove to be meaningless in practice. While the agencies have begun to reform their fair lending procedures, the number of discrimination cases remains low. The lack of community organizations in rural areas --together with the reluctance of residents of many small towns to take on their elite-- may significantly reduce the value of the "complaint" provision. Additionally, the rule does not specify what will constitute a "bona fide" complaint (particularly in light of the absence of statistical data).

Needed Changes: The small bank exemption provision is not justified on policy grounds, and is inconsistent with the legislative history of CRA. The small bank exemption should be eliminated, and small banks should be subject to the same standards and requirements as large banks, including public disclosure of lending data.

2. Lending Test for Banks and Thrifts With More Than $250 Million in Assets

The CRA reform initiative would focus an examiner's evaluations of lending performance on a comparison of an institution's market share of small business, home mortgage, and consumer lending in low- and moderate-income neighborhoods to its market share in the service area as a whole. This "relative" test is complemented by an analysis of whether the institution has made a "significant" number of loans throughout low- and moderate-income areas, or whether its total lending in low- and moderate-income areas is "substantial."

The market share methodology that is the basis of the lending test is a significant improvement over current practice, in that it focuses the attention of examiners on whether an institution is as aggressive in seeking out lending opportunities in low- and moderate-income neghborhoods as it is in the rest of its service area. This approach is far preferable to formula-based schemes, such as that proposed by the New York State Banking Department in its proposed changes to CRA.

Many of the specifics of the lending test, however, are troubling, and would undermine the value of the market share methodology. This section will discuss the rule's treatment of: indirect lending; the weighting of mortgage, small business, and consumer lending; the disaggregation of different kinds of mortgage lending; gentrification; targeting; and "adjustments" of the base lending score.

a. "Indirect Lending"

The proposal would allow lenders to count for CRA credit a proportionate share of loans made by third parties --such as community development banks-- in whom they had made equity investments. This would allow banks and thrifts to "buy out" of CRA, in effect to redline in their main business operations, but achieve compliance through non-lending activities.

This is clearly contrary to the spirit of CRA, which was intended to integrate community lending into the everyday operations of lending institutions, rather than to institutionalize a "separate and unequal" banking system for low- and moderate-income areas. In addition, the proposal appears to contradict the public statements of Administration officials that banks would not be able to achieve compliance with CRA simply thorough investments in CDFI's. Finally, the proposal threatens to undo years of progress in developing underwriting and marketing expertise in the mainstream banking industry with regard to community reinvestment. Loans made by mainstream lenders that have developed this expertise are of much greater long-term value to communities than

lending conducted through separate intermediaries.

Investments in affiliates of depository institutions --such as a mortgage bank affiliate or a bank CDC-- do not raise the same concerns. How a bank structures community reinvestment into its corporate organization is its own business. It is unacceptable, however, to move community reinvestment outside the banking organization altogether.

Needed Change: Indirect lending should not count for purposes of the lending test. Investments in community development entities that generate significant amounts of credit in low- and moderate-income areas should be evaluated under the investment test, if at all. In no case should a lender that itself fails the lending test get a "satisfactory" rating by virtue of "indirect lending."

b. Weighting of Home Mortgage, Small Business, and Consumer Lending

The proposal would have examiners conduct separate market share comparisons for small business, home mortgage, and consumer lending, and "an overall market share performance rating" would be arrived at "after weighing each lending category based on such factors as the needs of the community being served, the bank's capabilities and business plans, and the degree to which the bank's performance with respect to one of the loan categories, in fact, balances or compensates for its performance under another category."

It is not clear how examiners in practice will arrive at overall market share ratings in specific cases --how they will determine "community needs" or make judgements about disparate performance in different product lines.

The legislative history of CRA has consistently emphasized small business and home mortgage lending. For example, the conference report for FIRREA in 1989 stated that written CRA evaluations should "place special emphasis on the insured depository's record of serving the housing credit needs of low- and moderate-income persons, small business credit needs, small farm credit needs and rural economic development." The regulation itself does not explicitly give these product lines any greater weight than consumer lending --which has historically been of less importance in community development efforts and strategies.

Needed Change: Specify in the regulation that consumer lending will receive significantly less weight than home mortgage and small business lending, and that a poor record in home mortgage or small business lending will generally result in a less than satisfactory rating under the lending test.

c. Methodology for Analysis of Home Mortgage and Small Business Lending

The market share analysis would aggregate all types of mortgage lending for purposes of analysis, including home purchase, home improvement, multi-family, and refinancing orginations and purchases. This may greatly distort results and understates the particular need in low- and moderate-income communities for home purchase and multi-family credit. Refinancings and home improvement loans, while they may be of value to low- and moderate-income people, are not as important for community development purposes as home purchase and multi-family loans.

In particular, many lenders may do large volumes of home improvement loans in low- and moderate-income areas precisely because they do not offer home equity loans in those areas to the same extent as in high-income neighborhoods (home-equity loans are not reported under HMDA). Originations should get greater weight than purchases because they require underwriting and marketing efforts on the part of the lender.

Similarly, the analysis would aggregate all small business lending for purposes of the market share computation. Anecdotal evidece strongly suggests that the greatest problems of credit availability face very small businesses with sales of less than $100,000 annually. "Lumping" all small businesses together might mask problems faced by specific segments of the market. A new reporting category should be created to reflect this fact, and the market share analysis should be conducted for each of the five categories of small business.

Needed Change: Require examiners to conduct the market share test separately for home purchase, multi-family, refinancing, and home improvement loans, and state explicitly that greater weight will be given to home purchase and multi-family originations. In addition, a new category of small businesses --those with annual sales of less than $100,000 per year-- should be created for reporting purposes, and the market share analysis should be conducted for each of the five categories.

d. Gentrification and Displacement of Low- and Moderate-Income Households

Since the market share analysis focuses exclusively on lending to low- and moderate-income *neighborhoods* as opposed to *individuals,* lenders will get credit for loans to high-income individuals moving into or displacing low-income families. Gentrification --because it involves the rapid turnover of housing stock

3. Service Test

The service test would involve an analysis of the distribution of a lender's branches in a given service area, and a determination of whether the percentage in or readily accessible to low- and moderate-income areas was "substantial," "significant," or "insignificant." A lender's rating under the service test would also depend on the extent to which it offered services that promoted credit availability, including loan and homeownership counseling, loan packaging for small businesses, and basic banking and government check cashing. An "outstanding" rating under the service test would increase a lender's rating one level, and a rating of "substantial non-compliance" would reduce the rating one level. Other ratings under the service test would have no impact on the composite rating.

The service test raises two principal concerns. First, the use of terms such as "significant" and "substantial" leaves too much room for examiner discretion. In particular, the connotations of the terms "substantial" and "insignificant" suggest that many lenders might get "outstanding" ratings, and very few would get ratings of "substantial non-compliance."

Second, the terms of basic banking and government check cashing services are not adequately defined. Many lenders offer some type of lifeline account or check cashing service, but few offer services that are genuinely affordable or accessible to low- and moderate-income people.

Needed Change: The service test should involve much higher standards. In order to get an "outstanding" rating under the service test, the percentage of an institution's branches located in or readily accessible to low- and moderate-income tracts should be equal to or greater than the percentage of tracts in the service are that are at or below 80% of area median income (weighted for population). An institution whose percentage of branches in low- and moderate-income tracts is less than 50% of the percentage of all tracts in the service area that are low- and moderate-income (weighted for population) should be given a rating of "substantial non-compliance." Branches located in low-density downtown areas --which are often low-income by census criteria, but serve a middle-income or high-income clientele-- should not be counted for purposes of the analysis.

In order to receive favorable consideration, a basic banking account should at a minimum: require only a nominal opening balance and no minimum balance; allow full access to tellers; provide for fees that no more than cover costs of operating the account (including bounced check fees); and allow for at least 12 free checks per month. In order to receive favorable consideration, a

moderate-income neighborhoods might be lending exclusively to high income individuals, thereby facilitating gentrification and the displacement of low-income households. Or a lender might be lending in low- and moderate-income white neighborhoods to the exclusion of low- and moderate-income minority areas. Or it may avoid lending in low-income areas, and focus solely on moderate-income neighborhoods.

Needed Changes: The regulation should not contain language suggesting that upward adjustments are any more likely than downward adjustments. In addition, specific reasons for adjusting a rating downwards (like those listed above) should be listed in the regulation, just as the specific reasons for increasing a rating are itemized.

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government check cashing service should either be free or include only a nominal fee designed to recoup costs, and should not require excessive identification to be presented. Banks should demonstrate that the services are effectively marketed and extensively used before receiving any credit.

4. Investment Test

The investment test measures investments by institutions in specified activities that benefit low- and moderate-income neighborhoods relative to their risk-based capital. Examples of qualifying investments include investments in loan consortia, minority- and women-owned banks, community development financial institutions, or mortgage revenue bonds, provided that they benefit low- and moderate-income areas (a retail bank would get credit for all of its qualifying investments, provided that a portion benefited its service area).

It is probably appropriate to employ an investment test for wholesale and other special purpose banks (such as credit card banks) for whom retail lending is a relatively minor part of their ordinary business.

The role of the investment test with respect to retail banks, however, is among the most troubling features of the proposed CRA regulation.

Except for investments in minority- and women-owned banks that benefit low- and moderate-income neighborhoods, the statute focuses exclusively on lending activities. While there may be many sources for worthy investments in low- and moderate-income areas, only banks are able to provide long-term community development financing. For this reason alone, it is crucial to maintain the focus of CRA on lending.

Moreover, the standards for investment --a substantial amount relative to an institution's risk-based capital-- would appear to represent a retreat from current standards for lending. In terms of dollar volume, we would expect that lenders would devote far more resources if they were judged solely with respect to their lending activities than if they could achieve compliance through investments.

The provision of the investment test that allows banks to get credit for investments outside their service area(s) appears to sever the connection between lenders and *local* communities that is at the heart of CRA --and will become increasingly important as the banking system evolves.

Finally, the list of qualifying investments in the proposed rule appears to make almost no credible distinction among investments. For example, investments in mortgage revenue bonds are not a stretch for any lender --indeed, they confer concrete tax advantages for purchasers.

Needed Changes: Analysis of investments may be appropriate for special purpose institutions, but the exceptional case should not drive the rule. A retail institution with a less than satisfactory record of direct lending should not be able

to get a satisfactory or better rating by virtue of its investment activities. Otherwise, as the Federal Reserve analysis of the proposal puts it, "institutions that are less than satisfactory in lending may be able to 'purchase' a satisfactory rating through investments." This could potentially result in *less* lending in low- and moderate-income neighborhoods, and some lenders might get ratings of substantial non-compliance' under the lending test but get an overall rating of "satisfactory" by virtue of an "outstanding" performance under the investment test.

5. Rebuttable Presumption

The proposed rule would allow lenders to contest the initial ratings they receive from examiners through an appeals process. In fact the rule encourages "liberal use of agency appeals processes" in the early years of the rule's implementation.

The appeals process threatens the credibility of the new system, because it affords a behind-closed-doors opportunity for lenders to negotiate with the agencies regarding the ratings they will receive. Large and sophisticated lenders will undoubtedly use this provision to intimidate examiners. No comparable process is offered to citizens who believe that a CRA rating overstates a lender's performance.

Needed Change: Either the appeals process should be made equally available to the public, or it should be eliminated altogether.

6. Composite Ratings

The process by which the agencies will arrive at composite ratings is problematic for two reasons. First, the process by which the lending, service, and investment tests are balanced is likely to undermine the focus on lending. Second, the question of how composite ratings are to be arrived at in the case of lenders operating in multiple service areas within a state is left unclear.

a. Balance of Lending, Investment, and Services Tests

The legislative history of the Act, regulatory policy, and the community group posture have always pointed to the need to maintain the focus of CRA on lending. The proposed rule raises the troubling prospect that lenders with less than satisfactory records in lending will get satisfactory or better ratings by virtue of non-lending activities.

b. Composite Rating for Lenders With Multiple Service Areas Within A State

The proposed rule states that the lending, service, and investment tests will only be conducted in "sample" service areas for lenders with multiple service areas in a state. It is unclear whether or not the statistical portion of the lending will be conducted in non-sampled service areas.

The rule does not propose any guidelines for how sample areas will be selected, and more importantly how different ratings in different areas will be reconciled or weighted. It is irrelevant to residents of a given community that a large institution with branches throughout the state is performing at a certain level overall. Their focus will rightly be on the lender's performance in their own community.

Needed Changes: The rule must be altered to clearly state that any lender with a less than satisfactory performance under the lending test shall get a composite of less than satisfactory rating, regardless of its performance under the service and investment tests. With respect to lenders with multiple service areas, the expectation must be that a lender is to get a satisfactory rating in <u>all</u> its service areas.

Specifically, a lender with multiple service areas should not be able to get an "outstanding" rating unless it has an outstanding performance in more than 80% of its service areas, and it has a satisfactory rating in the balance of its service areas (which should not include any of its largest service areas, either in terms of population or its deposit base). A lender should not be able to obtain a "satisfactory" rating unless it has at least a satisfactory rating in 90% of its

service areas (including its largest service areas), and in no case has a rating of "substantial non-compliance." Any lender that gets a less than satisfactory rating in the same service area in two sequential evaluations should get a less than satisfactory composite rating, notwithstanding its performance in other service areas.

In addition, the rule should explicitly require examiners to disclose in the public portion of the CRA evaluation which service areas were sampled (and any rationale for the selection), as well as lenders' performance rating in each sampled service area.

7. Disclosure of Lending Data

The proposal would require the collection of data on housing, small business and closed-end consumer loans (except auto loans) for all lenders with more than $250 million in assets.

The provisions requiring additional public disclosure of lending data are the greatest strengths of the proposed regulations. The experience with HMDA data has been that public disclosure is by itself the most powerful force for change in the banking industry. Public disclosure of HMDA data has assisted lenders' own efforts to comply with CRA, facilitated fair lending supervision, empowered residents of low- and moderate-income neighborhoods, and has resulted in a revolution along every step of the mortgage lending chain, from underwriting to marketing.

The disclosure of lending data --especially for lending to small businesses and small farms-- is absolutely essential to implement the proposed performance-based methodology.

While the disclosure provisions are a significant step forward, they can and should be improved.

First, the proposal does not require collection of data on lending to minority-owned small businesses. There is considerable anecdotal evidence of credit availability problems for such firms. A provision of FDICIA provides broad authority to the agencies to collect and disclose data on the race and ethnicity of small business applicants and borrowers. (Requiring banks to collect data on the race and ethnicity of small business borrowers would require an amendment to the implementing regulations for the Equal Credit Opportunity Act [ECOA], but there is no statutory impediment to the collection of such data).

Second, the proposal does not require collection of data on loans to firms with less than $100,000 in annual sales. Such firms constitute a majority of small businesses in the country, and anecdotal evidence strongly suggests that these firms face the greatest difficulties in accessing credit from depository institutions.

Third, collecting data only from institutions with more than $250 million in assets may provide a very incomplete record of actual lending activities in particular communities.

Lastly, the rule does not clarify the means through which this data will be made available to the public. The Federal Reserve's obstructionist policy with regard to the release of HMDA data suggests that the rule must deal with issues of

dissemination and accessibility in an explicit fashion.

Needed Changes: The rule should require reporting on applications received, denials, and originations by the race and ethnicity of small business owners. The rule should also provide for a fifth "threshold" for small businesses --firms with less than $100,000 in annual sales. The regulations should provide for collection of data from all banks and thrifts with more than $10 million in assets --the threshold contained in HMDA. Clear policies regarding the dissemination of the newly collected data must be established in the rule, and should he governed by the principle that data should be made available in a wide variety of formats to facilitate use by a wide range of users --from academics to low-tech community groups.

8. Enforcement

The new rules clarify for the first time that the agencies may use the full range of enforcement powers available to them --including cease-and-desist orders and civil money penalties-- for institutions in "substantial non-compliance" with the CRA. This provision is fully consistent with the statute, which gives the agencies broadly defined powers to promulgate regulations to "implement the *purposes*" of the Act. The Federal Reserve, which has objected to the enforcement language, has actually used a cease-and-desist order in at least one case for persistent non-compliance with CRA.

Needed Change: The rule should not preclude the agencies from using the full range of their enforcement powers for lenders with "needs-to-improve" ratings. In addition, a lender should receive a rating of substantial non-compliance if it has received two --rather than three-- sequential ratings of needs-to-improve.

9. "Safe Harbor" Provision

The proposal contains an implicit safe harbor for banks achieving an "outstanding" or "satisfactory" CRA rating. While the proposal does not prevent the agencies from considering comments by the public in weighing the application of an institution with a satisfactory or better rating, it suggests that the new applications policy --for the first time explicitly laid in the rule-- would provide an "incentive" for banks to achieve a high CRA rating.

At the same time, the rule fails to address one of the principal complaints of community groups with regard to the enforcement of CRA --the unwillingness of the Federal Reserve to consider applications in an open and critical manner. Not only has the Fed refused to deny many applications, it has refused to hold public hearings or extend public comment periods in the case of major mergers involving dozens of communities and many requests for such procedures.

Since most applications are decided by the Federal Reserve Board, this new "safe harbor" policy will in all likelihood be implemented in a draconian fashion, and dramatically undermine the role of the public in fostering community reinvestment.

The proposed "safe harbor" is misguided on several counts. First, the new regulations are --by their authors own admission-- a radical departure from current practice, and may result in a wide variety of anomalies that cannot be anticipated. The agencies should not lower the weight accorded to public comment given that the new system has not been tested. Second, the agencies have apparently not decided how to arrive at a composite rating for banks with branches in many metropolitan areas. And they have stated that they only intend to "sample" representative market areas to arrive at the overall rating for such institutions. It is therefore plausible that an institution with a stellar record in sampled areas may in fact be doing a disasterous job in others --a subject that would only be raised by the public comment process. Third, the recurrent use of subjective terms such as "roughly comparable," "significant," and "substantial" in the rule suggests that examiner judgement will continue to play a central role in deciding CRA ratings. Such judgements are not infallible, and should be open to criticism.

CRA has worked because of public participation --and in spite of regulatory hostility and malfeasance. The new rule should build on --not discourage-- this record of citizen involvement.

Needed Changes: The portion of the rule dealing with applications must be deleted.

10. Role of Discrimination in CRA Evaluations

The proposed rule would greatly erode the role of fair lending in CRA evaluations. Specifically, under the "old" CRA, one assessment factor required examiners to look for "evidence of prohibited discriminatory credit practices or other illegal credit practices," while another required analysis to determine whether the lender was discouraging applications on a phohibited basis, or "prescreening."

Under the "old" CRA, extremely low levels of applications from minorities, or underwriting criteria with a discriminatory effect on minority neighborhoods might constitute sufficient evidence to warrant a lowered CRA rating. Alternatively, a lender that originated a large volume of loans to low- and moderate-income whites, but few to low- and moderate-income minorities would be subject to scrutiny under these assessment factors.

The proposed rule, by contrast, provides for a much narrower definition of discrimination, namely any individual case of discrimination that had not been fully corrected by the institution or which it is not in the process of correcting, or any pattern or practice of discrimination which it had not fully corrected at the time of the exam. Given the sorry record of the banking agencies in finding instances of discrimination --and the narrowness of the definition-- this is likely to prove a meaningless test.

It is important to note that the new focus on fair lending has yet to produce a significant uptick in cases or referrals to the Justice Department. In addition, the focus of the agencies has been almost exclusively on issues of *disparate treatment*. Other issues such as pre-screening and *disparate impact* have not been dealt with in the fair lending context. They should continue to be analyzed as part of CRA evaluations.

Needed Changes: The rule is correct in providing that discrimination should result in a less than satisfactory CRA rating. The proposed rule must be altered, however, to preserve the existing evidentiary standard with respect to discrimination. Specifically, evidence of discrimination should continue to include low levels of applications from minorities, disparities in the rejection or approval rates for white and minority borrowers, and loan underwriting standards or policies that have a discriminatory effect on predominantly neighborhoods. In addition, the lending analysis should also include market share breakdowns of home mortgage, consumer, and small business lending by the racial composition of neighborhoods.

11. Strategic Plan

The proposed rule allows all lenders to choose the option of creating a strategic plan with measurable goals to meet their CRA obligations, in consultation with community groups. However, the proposal does not include the mechanisms that would ensure that community groups are able to participate in the process, nor does it address how the agencies would respond to unfavorable public comment about the substance of a strategic plan. It is also extremely unclear how a strategic plan would be evaluated by the agencies. The rule provides for no specific comment period and only requires one-time newspaper notification by lenders of their intent to develop a strategic plan.

An additional concern is that many lenders may file strategic plans for a given area at the same time --thereby placing a tremendous burden on community organizations to comment.

Needed Changes: This provision of the rule must ensure that community groups are able to participate in the process as envisioned. Specifically, the agencies must regularly disseminate lists of lenders that are formulating strategic plans (the existing rule provides for only publication of notice by the lender in newspapers), and allow for no less than 90 days for public comment on a plan once it is filed. The agencies must also clearly state that the standards for institutions pursuing this option would be no less than for lenders that would be evaluated under the lending, services, and investment tests. Finally, in approving or disapproving a plan that has been commented upon unfavorably by the public, the agencies should as a matter of course explain their reasoning and respond in detail to specific issues raised by commenters.

12. Public Comment and Assessments of Community Need

A principal complaint by community groups about the implementation of CRA over the years has been that examiners often neglect to contact members of a lender's community --especially low- and moderate-income people-- prior to conducting a CRA exam. Such contacts are essential not only to verify claims made by lenders, but to get a "feel" for the nature of credit needs in a community, and the kinds of products that would meet those needs.

Indeed, the proposed rule --for all its emphasis on "objectivity"-- recognizes implicitly that meeting locally determined credit needs is at the heart of CRA. For example, in assigning a rating under the lending test to a bank with a stellar record in consumer lending, but an abomiable record in small business and home mortgage lending, examiners would weigh the different performances based in part on "the needs of the community being served."

However, the rule does virtually nothing to ensure that examiners get a sense from residents of local communities about what their credit needs are. Important decisions about CRA ratings will, therefore, be made in the absence of crucial information --information that can only be collected by examiner contacts with residents of local communities.

The proposed rule does provide that the agencies will publish 30 days in advance a list of institutions scheduled to undergo CRA examinations in the next calendar quarter, and allow for public comment. This provision --which would impose a substantial burden on community groups-- should not be a substitute for aggressive outreach by examiners. There is simply no substitute for proactive outreach by examiners to determine community perceptions and credit needs.

It is unlikely that community groups will be able to provide meaningful comments on the performance of potentially dozens of lenders in the short period provided for in the rule. Moreover, most community organizations simply do not have the resources or time to devote to responding to notices in the *Federal Register* --especially when they are unsure as to wbether their comments will be taken seriously.

Needed Change: The list of institutions to be examined should be published no less than 90 days in advance of the next calendar quarter. In addition, as part and parcel of every CRA evaluation, exmainers should be required to contact community groups regarding their perceptions of credit needs and lender performance, and to make use of the information in arriving at ratings.

CONCLUSION

The proposed CRA regulations represent dramatic change. Whether the regulations will fulfill President Clinton's promise to strengthen CRA will depend largely on how key questions are resolved in the final rule.

The rule contains several positive features, including a stronger focus on lending in low- and moderate-income areas, public disclosure of lending data, and the introduction of the concept of market share analysis.

Key areas where the rule must be changed include: the role of investments and indirect lending in the evaluation process; the proposed "safe harbor" provisions; the treatment of small banks; the evidentiary standard for discrimination; the implementation of the strategic plan concept and the role of the public and community groups in the CRA process; the rebuttable presumption and adjustments provisions; several aspects of the market share methodology; and the way in which composite ratings for institutions with multiple markets would be determined.

Ultimately the regulation --unless significantly strengthened-- could result in less community reinvestment in low- and moderate-income neighborhoods around the country. Conversely --if significantly strengthened-- the rule could potentially enhance credit availability in low- and moderate-income areas, and fulfill the President's commitment to strengthen CRA.

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TESTIMONY BEFORE THE HOUSE SUBCOMMITTEE

ON CONSUMER CREDIT AND INSURANCE

SUBMITTED BY GALE CINCOTTA

EXECUTIVE DIRECTOR OF THE NATIONAL TRAINING AND INFORMATION CENTER
AND CHAIRPERSON OF NATIONAL PEOPLE'S ACTION

FEBRUARY 8, 1994

Thank you, Mr. Chairman and other members of the Committee for this opportunity to testify, and for your interest in community reinvestment. I speak not only as Executive Director of the National Training and Information Center, but as Chairperson of National People's Action. NPA is a nationwide coalition of over 300 grassroots organizations working on a variety of neighborhood issues since 1971.

Community reinvestment is one of the most important means to address the lack of credit in our nation's low and moderate income neighborhoods. Since the Community Reinvestment Act's inception, the National Training and Information Center has negotiated over $12 billion dollars in lending commitments for low and moderate income communities. The Act itself has never been difficult to understand. However finding a means to enforce the Act has been problematic.

I would like to applaud the President and Mr. Eugene Ludwig, head of the Office of the Comptroller of the Currency for their efforts to reform the community reinvestment act. For too long, community groups have been telling the regulators that much was needed to improve and to strengthen the Community Reinvestment Act and the way in which lenders are evaluated and graded under this system. For the past several years, the regulators have not concentrated on the intent of the CRA, rather they have focused too much on the process.

I believe that the proposed regulations, led by the OCC, are a step forward for the Community Reinvestment Act and for all those who have the ability to benefit from increased access to credit. The new regulations go a long way in returning the focus of the Community Reinvestment Act back to the original intent of the law: Are loans being made in low and moderate income communities?

First, let me say that I am extremely happy to see that the new regulations are performance based rather than process based as in the past. Because the Assessment Factors were subjective, lenders tended to overcompensate for uncertainties about their exams and the way in which the examiners may interpret their performance. This ultimately led to excessive documentation by the lenders and a backlash against the Community Reinvestment Act. Such detailed reporting was never the aim of the CRA statute, nor was it suggested or desired by community residents active in community reinvestment. Performance-based standards allow the entire CRA process to focus on lending performance which was the original intent of the law.

Communities have suffered for too long as we watched lenders center their efforts on marketing and advertising plans, paper trails, and phone logs. We have watched as banks received Satisfactory, even Outstanding ratings without making any loans in low and moderate income neighborhoods. Currently, over 90% of all lending institutions receive Satisfactory or better CRA ratings. Requiring lenders to meet measurable performance standards assures the community that they are, indeed, making loans.

Although the proposed regulations do move the CRA process from subjective to performance based standards, other areas of the regulations raise many concerns for community organizations.

The frequency of CRA examinations for banks receiving "Outstanding" ratings should not be reduced. Until the community can be certain that an Outstanding rating means that an institution has met the credit needs of its entire service area, banks cannot be rewarded for such a performance. Before relieving the banks from their CRA obligations, let's allow time for the new regulations and their effects to take place. Consistent rating for three years are needed before reducing a bank's frequency of examinations can be considered.

Although a streamlined examination for small banks may be warranted, the proposed asset size determination is much too large. Currently, nearly 80% of all lending institutions would fall under the $250 million asset size category and would be exempt from more rigorous lending standards. Small banks should be defined as those with assets of less than $100 million. In addition, for small banks, the loan-to-deposit ratio should be increased from 60% to 75%.

Small banks should also be subject to the same service test as large institutions. It cannot be assumed that small banks automatically meet the credit needs of the community in which it is located, particularly if the definition of small banks remains at $250 million. Small banks, like larger institutions need to be encouraged and evaluated on the availability of banking services as well as credit. Providing banking services is an integral part of an institution's obligation to meeting the credit needs of its community. The size of an institution does not guarantee that it will provide appropriate banking services for all those within its service area. Therefore, all banks must be subject to a service test.

Under NO CIRCUMSTANCES should a bank's composite CRA rating be adjusted up to two levels, or even one level, for an Outstanding rating in the investment test. Allowing a bank to increase its composite rating by two entire levels, removes the incentive for the bank to lend directly in low and moderate income communities. With such a system in place, a lender with a Substantial Non-Compliance rating for the lending test could end up with a composite rating of Satisfactory if they received an Outstanding rating for the investment test.

This removes the lender's responsibilities to lend directly in low and moderate income communities. Once again, unscrupulous lenders will be able to obtain high CRA ratings without directly providing loans to low and moderate income communities. While this approach may be appropriate for wholesale and special purpose banks, its does not make any sense for retail banks whose primary purpose is to provide direct lending services. The idea behind reforming the CRA process was to emphasize a lender's lending performance, not mitigate this activity with increased credit for investment performance.

I am afraid that allowing a lender to receive such increases for its investment performance will consequently result in the elimination of a functional conventional market in those areas. The Community Reinvestment Act is not just about reinvesting in neighborhoods, but about **RESTORING THE CONVENTIONAL MARKET** in underserved areas. Community groups

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want and need lenders to make investments. However, they also need to be able to walk into a lending institution located in their neighborhood and apply for mortgage credit.

For the same reasons, a lender should NOT be allowed to receive an increase in its composite CRA rating for an outstanding service performance. Again, this would result in a shift in emphasis from direct lending to merely providing banking services. While banking services are an essential part of a bank's obligation to meeting the credit needs of a community, an outstanding rating on the service test should not result in an increase in the composite rating. Care should also be given to insure that non-traditional branches, such as mini-branches in the grocery stores, do not serve as substitutes for actual bank branches that provide full banking services. An institution's non-traditional branches should enhance its service rating but not replace its obligation to provide traditional branch services.

One of the most exciting aspects of the new regulations is the possibility of getting business loan data. In 1975, when the Home Mortgage Disclosure Act was intially introduced, it was called the Financial Institutions Reporting Act. It included not only public disclosure of residential mortgage loans by census tract, but disclosure of commercial loans as well.

For over twenty years, National People's Action has been telling the regulators, the bankers, and legislators that small business and small farm lending data is absolutely crucial to community revitalization. In the same way in which the Home Mortgage Disclosure Act (HMDA) dramatically increased the amount of housing loans, disclosure of small business data will provide the community, as well as the lenders, with the information needed to develop innovative lending programs for small business and small farms. Small business development is one of the most promising routes for economic development and job opportunities in disinvested neighborhoods. Providing this data will be the quickest way to truly revitalize low and moderate income communities.

However, in order for communities to truly achieve this goal, the categories for small business must be greatly reduced. When neighborhood groups speak of small business and small farms, we speak about truly small business. Those whose annual sales are much less than $250,000. In order to get an accurate picture of what is happening in inner-city and rural low income communities, the categories must be broken down as follows: business with sales of less than $50,000; those with average annual sales of $50,000-$100,000, those with average sales of $100,000-$250,000; and those with average sales of $250,00-$500,000.

Small business and small farm loan data should be required by all institutions except those already exempt from HMDA data.

Like small business data, small farm loan data must also be reported according to annual gross farm income. The categories must be broken down as follows: farms with annual gross farm income below $100,000, annual gross farm income of $100-$150,000; those with annual farm income of $150,000-$200,000, $200,000-250,000; and those above $250,000 in annual farm income. Only with these categories in place, will the community, lenders, and regulators be

able to determine whether or not the bank is meeting the credit needs of small and mid-sized family farmers.

A lender's CRA plan cannot substitute for actual loans in underserved areas. The communities do not care if a lender has a strategic CRA Plan if there are no loans made in low and moderate income neighborhoods. Loans must be made in these areas, regardless of whether a lender has a CRA plan.

Using market share to determine whether or not a lender is meeting the credit needs of low and moderate income neighborhoods works only if a lender is making a large amount of loans in higher income, non-risk areas. Regardless of a lender's lending activity in higher income areas, lenders must have a reasonable amount of loans in low and moderate income neighborhoods. Low and moderate income neighborhoods must have a variety of appropriate loan products available to them. Just because a lender does not offer certain lending products, does not justify inaction in those areas. Lenders must figure out a way to offer the appropriate products.

Banks must also continue to provide the public and the regulators with a CRA statement. However, this statement need not be any longer than a one to two page statement describing the bank's service area (including a map), hours of operation, branch locations and hours, ATM locations, loan products, and banking services available. The public has a legitimate right and interest in knowing what loan products and services are available to them. A CRA statement allows the community to hold a lender accountable and to determine whether its needs are being met. In addition, this statement should inform the public about the purpose and availability of a lender's public CRA comment file.

Of great concern to community groups is the opportunity for banks to achieve a Safe Harbor. Currently, the way the transition rules are written, there may be an opportunity for lenders to achieve a safe harbor from the new CRA regulations. By July 1995, sufficient time has been given for banks to comply under the new regulations. After this date, they should not be allowed to be evaluated under the old standards.

In addition, if banks are examined less frequently due to Outstanding performance, this is a Safe Harbor. Until there is some real meaning attached to ratings, the idea of exempting institutions from review is distressing. Banks should not be rewarded for meeting the requirements of what is law.

Further possibilities for a Safe Harbor lie in the transition rules. A bank's application would not be upheld nor would they be subject to enforcement actions if their first rating under the new system was more than one rating below the institution's last rating under the old standards. This is absolutely unacceptable.

The greatest power of a community group lies in its ability to challenge a bank's application if its lending performance is unsatisfactory. However, it appears that the new regulations attempt to reduce this power if a bank has an Outstanding rating. CRA ratings will be an "important,

and often controlling, factor" on bank applications. An "Outstanding" rating will receive "extra weight" in the application process and will result in a finding that the CRA aspect of the application is consistent with approval. Again, before we provide carrots to the banks, let's give the regulations time to take effect. Ratings must not take the place of the public's comments regarding a lender's performance.

For wholesale banks, indirect lending must play a role in how they are evaluated. Currently, wholesale banks are evaluated primarily on their investments. However, investments do not go far enough. A good way to insure that wholesale banks are making substantial investments in low and moderate income communities is to require them to participate in indirect lending. Indirect lending would insure that these banks are producing something new and would represent direct investments to low and moderate income neighborhoods. In addition, investments should be measured against a bank's assets, not its capital.

The value of improving examiner training and the need for consistency between the four regulatory agencies should not be underestimated. If the proposed regulations are to improve the current system and are to have a positive effect on the way the Community Reinvestment Act is interpreted, then we must have qualified and knowledgeable examiners who understand the intent of the Community Reinvestment Act.

Thank you for the opportunity to testify.

**STATEMENT
OF THE
CONSUMER BANKERS ASSOCIATION
AND
THE BANKERS ROUNDTABLE
BEFORE
THE SUBCOMMITTEE ON
CONSUMER CREDIT AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
CONCERNING
COMMUNITY REINVESTMENT ACT REFORM**

February 8, 1994

The Consumer Bankers Association (CBA)[1] and The Bankers Roundtable[2] (collectively, the Associations) appreciate the opportunity to provide this statement in conjunction with the Subcommittee hearing on Community Reinvestment Act reform.

The Associations firmly believe that CRA has been successful in promoting community development and that banks can continue to play a key role in achieving our community development goals. We appreciate the extensive efforts undertaken by the financial institution regulatory agencies to improve regulations under the Community Reinvestment Act, and we believe that regulatory reform -- and not legislative reform -- is the best vehicle for addressing the concerns of financial institutions, community groups and the public about CRA.

For a variety of reasons, CRA regulation has not fulfilled everyone's expectations. Some lenders have found that the implementing regulations are too process-oriented, and many community advocates have not seen as much in the way of results as they have wanted. Many believe that the current CRA regulations put too much emphasis on documentation and not enough emphasis on providing credit to improve our communities. These concerns have been the driving force behind the reform process.

But despite all these problems, CRA as currently enacted has not been a failure. It has been responsible for successfully putting billions of dollars into low- and moderate-income communities. And it has encouraged many financial institutions to recognize that there is a market in the revitalization of their communities and to find creative ways to address the needs of low- and moderate-income neighborhoods. The evidence demonstrates that much progress has been made.

For example, in October 1992, the Consumer Bankers Association released the results of its survey of affordable mortgage programs by financial institutions. The survey reviewed programs at 140 large and medium-size banks, thrifts and holding companies. While covering only part of the industry, the survey demonstrates that banks have been making a <u>major</u> <u>commitment</u> to affordable mortgage programs and related efforts to increase mortgege lending to minorities and low- and moderate-income consumers.

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1 The Consumer Bankers Association was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 750 federally insured bank and thrift institutions that hold more than 80 percent of all consumer deposits, and more than 70 percent of all consumer credit held by federally insured depository institutions.

2 The Bankers Roundtable is an organization of about 115 of the nation's largest banking organizations. The Bankers Roundtable was founded in mid-1993 through the merger of the Association of Reserve City Bankers and the Association of Bank Holding Companies.

In 1992, more than 90 percent of the banks surveyed had programs to increase mortgage lending to the target groups - - the most common of which involves more flexible underwriting criteria. In addition, a large majority of the banks are providing automatic reviews of mortgage loan rejections, stepped-up marketing to minorities, credit counseling and employee sensitivity training. The programs are quite new: on average, they are only two and one half years old. Therefore, the benefits are only beginning to be visible but the early signs suggest that efforts under the present system will be increasingly evident as these programs are refined and enhanced based on actual experience.

CBA repeated its survey in 1993, and the survey shows significantly <u>increased</u> efforts to provide affordable mortgage products. The overwhelming majority of banks surveyed for 1993 offer products which involve lower down-payments, make use of alternative credit history standards, or feature flexible debt-to-income, loan-to-value, or credit history standards. Eighty-eight percent of the 103 respondents have a policy that automatically requires a review of rejected loan applications. The number of loans originated under affordable mortgage programs by the surveyed banks and the total dollar volume of those loans also substantially increased from 1992 to 1993.

In addition, the CBA recently compiled a compendium of existing community development activities and vehicles used by financial institutions. This compendium, entitled, "*Taking Responsibility*: Financing America's Community Development in 1993," shows both the large number of programs and the great variety of mechanisms employed for CRA-related lending -- whether affordable mortgage, small business or consumer lending. In eech case, banks choose the methods of achieving their goals that are best suited to their product offerings and the needs of their local communities.

The compendium displays the gamut of programs in existence, from bank community development corporations to small business investment corporations to community development loan funds. It demonstrates the tremendous commitment to CRA lending by financial institutions, and belies the argument that banks are not actively engaged in this effort. The compendium is currently being updated and we will make it available to the Subcommittee when it is ready.

The surveys and the compendium offer evidence of the increasing success of CRA. Nevertheless, CRA regulation can be improved. Changes can be made that would (1) reward performance over process, (2) provide sufficient flexibility to enable institutions to adjust to local needs using their own unique strengths and product offerings, (3) improve the consistency of the examination and enforcement process, and (4) create greater incentives to encourage outstanding achievement. Regulatory changes must, however, be aimed at preserving and encoureging the areas of success under current CRA regulations. <u>No one wants changes that will divert resources from or otherwise seriously undermine the successful CRA programs and activities currently in place</u>.

We believe that any necessary changes in CRA are best effected by the financial institution regulatory agencies and that legislative reform is not necessary. We find the agencies' CRA reform proposal a good indication of precisely how difficult it is (even within the relatively flexible realm of bank regulation) to improve the existing system. In endeavoring to respond to the concerns of the community, including its bankers, the particular proposal issued by the agencies raises many important issues that must be resolved favorably before we can be certain that it will represent an improvement over the present form of CRA regulation.

CRA reform should result in greater clarity and certainty with respect to what activities "count" as CRA activities, but reform should not create a rigid structure that inhibits creativity and flexibility. CBA's compendium of community development activities and vehicles shows that there is a great variety of CRA programs currently in existence. We do not want to see changes that would in any way stifle the ability of institutions to fashion unique programs tailored to their communities' needs and the bank's own strengths.

We have asked for and received additional time from the regulators for public comment on the proposal. We believe that the additional time will be necessary to address all the issues raised by the agency proposal. For purposes of this hearing, we would like to offer our testimony regarding some of the most serious issues, the first being those raised by the Lending Test.

LENDING TEST

First and foremost, we are concerned about whether the market share formula is the appropriate way to measure the performance of financial institutions in meeting community needs. The market share formula (which is the primary component of the Lending Test) compares an institution's market share of loans in low- and moderate-income areas to its market share elsewhere in its landing area.

We believe the market share formula may be an imperfact and risky way to test CRA compliance because it would encourage financial institutions to engage in unsafe and unsound practices. Competing institutions will be tempted to "buy" market share through aggressively low landing standards, thereby potentially undermining safety and soundness and jeopardizing the very neighborhoods and people we seek to serve.

A lender will not be judged on whether it is actually helping to meet local credit needs, but instead on its market share of CRA loans compared to other institutions located in its market area. Thus, it does not necessarily yield more loans in the community. A lender will only excel at the expense of one or more competitors regardless of absolute performance. Whether a lender obtains adequate market share in low- to moderate-income loans is likely to have more to do with the competition among lenders in their market area than with true CRA performance. Lenders will be

tempted to sacrifice their lending standards to protect or increase their market share. The result could, therefore, be the same volume of loans having lower credit quality.

Additionally, because the test is an annual one based on past performance, in competing for market share banks will be essentially working in the dark. Since the reporting is only annual, banks will not be able to monitor their own performance relative to the performance of their competitors during the year. They may think they are doing well, but they will not know for sure until they see the competition's figures (by which time it will be too late).

The examiners will rely on reported data to determine market share performance, but by the time of the exam, the reported data is likely to be stale. The lender will not be graded on its current performance but on its historical performance. Evidence that an institution's current performance is better than its past performance will require extensive documentation of the type CRA reform was supposed to eliminate, and with no indication of the weight it will receive during an exam.

The Lending Test also fails to provide sufficient weight to provide incentives for many activities that are necessary to promote community development. It allows for certain adjustments if an institution makes a substantial amount of loans requiring innovative underwriting or loans for which there is special need, such as loans for multi-family housing construction and rehabilitation, loans to start-up or very small businesses, loans to community development organizations or facilities, loans to community development lending institutions, and loans to very low-income individuals and areas. The proposal states that the agencies will give these loans particular consideration. An adjustment to the score could also be made if the institution employs a "second look" program for denied applicants.

We are concerned that the proposal gives inadequate weight to some of the most valuable activities that institutions engage in for community development. These are some of the vital programs that have burgeoned under CRA, and any successful revision to CRA should give them the consideration they deserve and encourage their continued development.

INVESTMENT TEST

The Investment Test would measure "qualified investments" in organizations or initiatives that foster community development, small and minority-owned business development, or affordable housing lending, including state and local government agency housing or revenue. An outstanding rating would be given for investments that are substantial when compared with the institution's risk-based capital.

We are concerned that comparing qualified investments to risk-based capital essentially penalizes well-capitalized banks. The current regulatory structure encourages a large capital base, but the CRA proposal would set a higher investment

standard for these banks. For this reason, we prefer to see qualified investments measured against some more appropriate benchmark. We are currently working on alternative methods of assessing investment performance.

Regarding the coverage of the Investment Test, we are troubled by the possibility of failing to get credit or failing to get sufficient credit for significant investments. The coverage of the test is at best vague. For example, it is not clear whether it would include low-income housing tax credits as qualified investments. In addition, it gives only secondary consideration to partnerships with community organizations.

STRATEGIC PLAN

Although we generally support the agencies' efforts to provide an alternative means of achieving CRA compliance, we are concerned that permitting adoption of a strategic plan is not a real alternative unless the institution's strategic plan is permitted to address local needs by departing from the standards set forth in the CRA regulations. It is unclear how many institutions, if any, would choose to submit a strategic plan for approval (which would be the basis of its CRA assessment) if the institution is actually still subject to the lending, investment and service tests. The only result of submitting a plan would be a double CRA review, first under the plan and then under the regulations.

Beyond this, the fact that the plan must be published for comment makes what is ostensibly a business plan into a public document. In the competitive environment that would be created by the need to achieve market share, this would make the plan option undesirable.

APPLICATIONS

Under the agencies' proposal, the CRA rating would continue to be an important and often controlling factor in assessing the CRA aspect of a regulatory application. We support this, but encourage the agencies to provide even greater certainty to institutions of the impact of an outstanding CRA rating. Having a regulatory application held up for CRA reasons, either as a result of community protests or at the initiative of the regulators, is extremely costly. To eliminate or substantially reduce that risk for institutions rated outstanding would be a great incentive for institutions to achieve that rating. The regulations should offer more assurance that CRA factors would not defeat an application of an institution with an outstanding rating. We egree with the concept that institutions with outstanding CRA ratings should be examined for CRA less frequently, and would encourage the use of any further incentives to achieving outstanding ratings.

SMALL BUSINESS DOCUMENTATION AND DATA COLLECTION

We are quite concerned that the additional data collection requirements could inadvertently result in a substantially increased burden to depository institutions. This may be true for three reasons. First, it will be extremely difficult for financial institutions to gather and report the required information on small business loans. Many financial institutions do not require a small business to complete a loan application, and those that do often do not request an application until the loan is about to close. Requiring financial institutions to change this practice will be costly, and may deter small businesses from approaching banks for loans.

Second, collecting information on the average annual gross receipts for service businesses and the number of employees for manufacturing businesses will be extremely costly. At present, institutions collact small business data for Call Reports by loan size. Substantially more cost would be involved if they would also have to determine and monitor the sales volume and employee size of every loan customer.

Finally, the time period allowed for collecting, checking for accuracy of, and reporting the data appears impossibly short. We recommend that the January 31 deadline for reporting summary CRA data for the previous calendar year be extended to a more realistic deadline, such as March 31. At present, institutions have until March 1 to report the Home Mortgage Disclosure Act data and are barely able to accomplish it in many cases. The difficulties would be enhanced (not diminished) under the proposal.

TRANSITION PERIOD

Finally, the transition period is far too short to allow banks the needed time to adjust to the new regimen. CRA is being reinvented. Under the proposed scheme, financial institutions will have to completely change their business practices. Examiners will need extensive training and field experience. Massive amounts of new data will be collected and reported, with all the attendant problems of software creation and modification and error prevention. Yet the regulation will allow very little time (only a few months at best from issuance of a final regulation) before data will have to be collected (July 1, 1994), and only a short interval during which the new approach will be optional (April 1, 1995-July 1, 1995). Many banks will not even be examined during that period. Those that are examined will be measured egainst market share data concerning a very brief period, with the result that the test may be even less meaningful. In light of the dramatic nature of the changes in CRA requirements made by this proposal, we think that imposing the data collection and reporting requirements effective July 1, 1994 does not give institutions sufficient time in advance of that date to revise their policies and procedures.

We are also troubled by the difficulty institutions will have planning for the future during the first years of the new exam procedures. Data on previous years will be

unavailable and institutions will not ba able to make meaningful decisions about the future. Some attempts have been made in the proposal to minimize the harm to institutions during this transition period; however, we would welcome even greater efforts to treat this period as a "trial run."

CONCLUSION

In summary, we are troubled with a number of the provisions of the reform proposal and are working on developing our response to the agencies. Nevertheless, we do believe that, given the flexibility of the CRA statute, regulatory changes provide a more workable mechanism for implementing ongoing improvements in CRA than new legislation. We are grateful to have been given the opportunity to offer our views on CRA reform.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

April 6, 1994

The Honorable Joseph P. Kennedy II
Chairman
Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

I appreciate having had the opportunity to testify before your subcommittee recently. The responses to your follow-up questions are attached hereto.

I continue to be gratified by the keen interest and concern you exhibit on the CRA Reform Initiative. I look forward to an on-going working relationship with you and your subcommittee as we move toward final CRA regulations.

Sincerely,

Eugene A. Ludwig
Comptroller of the Currency

Enclosure

RESPONSES TO QUESTIONS FOR THE RECORD
FROM EUGENE LUDWIG
COMPTROLLER OF THE CURRENCY
MARCH 21, 1994

Q.1 **Would you please describe the rationale for allowing a lender who has received a very poor grade in the lending test to "bump up" its composite CRA rating by as many as two grades?**

Couldn't lenders who do almost no lending in low- and moderate-income areas end up receiving a "satisfactory" or "outstanding" CRA rating if they choose to make an investment considered to merit an "outstanding" rating?

A.1 The investment test evaluates banks on the amount of their qualifying investments (relative to the institution's risk-based capital). This includes those investments that demonstrably benefit low- and moderate-income geographies or persons in the bank's service area. Such qualified investments could include support of affordable housing, small business, consumer, and other economic development initiatives; investments in community development banks, community development corporations, community development projects, small business investment corporations, minority small business investment corporations and minority- and women-owned financial institutions and other community development financial intermediaries; and investments in state and local government agency housing bonds aimed at helping low- and moderate-income communities and individuals. Such investments are given credit under our proposal because they enhance the flow of funds to entities with substantial experience and expertise in channeling credit and other resources to traditionally underserved segments of the community.

For a retail bank, its rating under the lending test forms the basis for its composite rating. This rating would be increased by two levels in the case of outstanding investment performance or by one level in the case of high satisfactory investment performance. Therefore, it is conceivable that a bank with a lending test rating of substantial noncompliance could receive an overall rating of satisfactory with outstanding investment performance.

Q.2 **The General Accounting Office has questioned the capacity of examiners to take on the workload anticipated as a result of the proposed regulations. They point out that while new data will be provided by larger banks, many examiners do not now use the Home Mortgage Disclosure Act (HMDA) data supplied by lenders because they do not have the time.**

What steps have been taken by your agency to anticipate the increased workload for examiners?

A.2 Because we have a proposed, not final, rule we have not yet put into place all the changes or programs that would be required to implement the rules if they were to be adopted as currently proposed. However, there are a number of changes that are not dependent on the precise form of the final rule that we can share with you.

We have already started to implement a restructuring of our compliance program, which includes the use of specialist consumer compliance examiners, improved examiner compliance training, and revisions to examination procedures.

A new training program has commenced for our cadre of specialist consumer compliance examiners, which includes those who conduct CRA and fair lending exams. We have already conducted training at the Washington, D.C. headquarters and starting this month will send a training team to each of our six districts. We also have plans to implement new intermediate training courses and seminars. In the area of fair lending, we are using new, more elaborate procedures adopted subsequent to my appointment as Comptroller.

We believe the changes in procedures and training will result in an examination workforce with special expertise in consumer compliance, particularly CRA, as well as common training and basic experience in all aspects of bank examination. Under the new compliance program, compliance examinations are to be completed at least every other year in all banks. Examinations or follow-ups may be conducted more frequently based on the assessed need in individual institutions.

Q.3 **For larger institutions (those with over $250 million in assets), new data on small business, small farm, and consumer loan applications will be required. Currently, the error rate for HMDA data reported by institutions is estimated to be as high as 30-40 percent.**

What procedures will the agencies put in place to check the accuracy of the new data collected from larger lenders? Would you agree that unverified data is of little practical use?

In a related matter, how useful will this data be if it is not broken down by gender and by race, as is now required for HMDA data?

A.3 Unverified data would be of little practical use. Therefore we will develop examination procedures to allow examiners to verify data on-site. The new system will be more than adequate to handle the increase in data collection, should the final rulemaking adopt such a requirement.

The data proposed to be collected would provide information on the geographic distribution of small business and consumer loans. These data are not currently available. This data would provide valuable information about the extent to which an institution serves its community. Inclusion of data broken down by race and gender would provide additional information, and was considered in developing the proposal. In developing a final rule we will, of course, reevaluate the proposed data collection in light of public comments.

Q.4 **Smaller banks have complained that the 60 percent loan-to-deposit ratio included in the "small bank test" is unfair, since some institutions just don't make a lot of loans.**

Could you describe how you arrived at the 60 percent figure? What other options did you consider as a test? Please be specific.

A.4 The 60 percent figure was settled on in the proposed rulemaking because it would reduce uncertainty regarding ratings for roughly half of all community banks--those that have loan-to-deposit ratios that meet or exceed the threshold. There has been, however, some misunderstanding, or misinterpretation of this proposal among reviewers/commentors. The 60 percent loan-to-deposit ratio is not a requirement. Those institutions qualifying for the small bank examination and possessing a loan-to-deposit ratio of at least 60 percent would be presumed to have a reasonable loan-to-deposit ratio. An institution with a loan-to-deposit ratio below 60 percent would have the reasonableness of its lending ratio evaluated taking into account its size, its financial conditions, and the credit needs of its community. A bank in a community where there is insufficient loan demand to reach a 60 percent ratio would only need to have a ratio that is reasonable given its capacity and the level of demand.

In developing the small bank examination, we explored a number of options that were ultimately included along with the loan-to-deposit assessment in the proposed regulation. Specifically, in addition to the loan-to-deposit ratio, we proposed that a small bank be evaluated on whether it (1) makes the majority of its loans in its service area; (2) makes its loans across economic levels; (3) has no legitimate, bona fide complaints from community members; and (4) has not engaged in a pattern or practice or individual instance of illegal discrimination that it has not corrected fully. Additionally, in the case of a bank subject to reporting home mortgage lending data under HMDA, we would examine the geographic distribution of such loans.

Office of Thrift Supervision
Department of the Treasury
Director
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6590

March 29, 1994

The Honorable Joseph P. Kennedy II
Chairman
Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Please find enclosed for the record responses to the follow up questions submitted in conjunction with your February 8, 1994 Community Reinvestment Act reform proposal hearing.

If I may provide further information, please do not hesitate to contact me.

Sincerely,

Jonathan L. Fiechter

Jonathan L. Fiechter
Acting Director

Enclosure

OFFICE OF THRIFT SUPERVISION

ANSWERS TO QUESTIONS POSED BY CHAIRMAN KENNEDY

ON CRA REFORM

1. **Describe the rationale for allowing a lender who has received a very poor grade in the lending test to "bump up" its composite CRA rating by as many as two grades. Couldn't lenders who do almost no lending in low- and moderate-income areas end up receiving a "satisfactory" or "outstanding" CRA rating if they choose to make an investment considered to merit an "outstanding" rating?**

The proposed CRA regulation attempts to recognize the value of three very different but important performance categories in assessing an institution's record under the CRA: lending, investment and service. In order to reach a fair assessment of an institution's CRA activities, the agencies proposed a rating system for retail institutions that is based on lending performance, but also considers an institution's investment performance and provision of services to its community. The agencies based the composite rating on lending because we believe that lending performance is the most important of the three factors.

There are four composite ratings required by the CRA statute: Outstanding, Satisfactory, Needs to Improve and Substantial Noncompliance. However, in determining an institution's performance under the lending, investment and service tests, the agencies agreed that a five-level rating structure for each performance area might measure performance more accurately. Thus, each institution is assigned a base rating of Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, or Substantial Noncompliance under the lending test. That base rating can be increased by two levels if an institution's investments are rated Outstanding or by one level if they are rated High Satisfactory. In addition, an institution's base rating can be increased one level for outstanding performance under the service test or decreased one level for a rating of Substantial Noncompliance under the service test. In order to translate the five-level rating to a composite rating, both High Satisfactory and Low Satisfactory are rated as Satisfactory.

You ask whether a lender who does almost no lending in low- and moderate-income areas could receive a Satisfactory or Outstanding rating if it makes an investment considered to merit an Outstanding rating. It is possible for an institution with a low level of lending in low- and moderate-income areas to raise its composite rating to Satisfactory because of an outstanding investment test performance. However, in order to merit an

Outstanding rating under the investment test, an institution would have to demonstrate performance beyond one investment as your example implies. The investment test requires that an institution must make investments that are substantial as compared to its capital in order to achieve an Outstanding rating.

We believe that the proposed rating structure allows each institution to approach its CRA obligations in a manner tailored to its particular circumstances. An institution that may not have many lending opportunities but does invest substantially to benefit the low- and moderate-income areas of its community might merit a Satisfactory composite rating.

The proposal recognizes that strict application of a rating formula may result in a situation where an institution's performance ratings do not reflect their actual performance. The proposal, therefore, incorporates some flexibility before assigning a final rating by indicating that the ratings are presumptive; that is, they may be adjusted by the regulator if performance under the lending, investment, or service tests does not reflect an institution's actual performance.

2. **The General Accounting Office has questioned the capacity of examiners to take on the workload anticipated as a result of the proposed regulations. They point out that while new data will be provided by larger banks, some examiners do not now use the Home Mortgage Disclosure Act (HMDA) data supplied by lenders because they do not have the time. What steps have been taken by your agency to anticipate the increased workload for examiners?**

The efficient allocation of examination resources is a constant challenge. To meet our statutory obligations, we take a "top-down/risk-focused" approach to our compliance examinations. This approach emphasizes a thrift's ability to manage its compliance responsibilities. For instance, our fair lending examination procedures (which are also relevant in the CRA assessment process) include a comprehensive review of loan policies, underwriting standards and processing procedures, lending patterns, self-assessment efforts, staff training and discussions with management and lending personnel. Our examiners use HMDA data to identify significant disparities associated with applicant or neighborhood characteristics such as race or racial composition as part of their review of lending patterns.

We have been particularly concerned with providing useful analysis of HMDA data to our examiners. Through the Federal Financial Institutions Examination Council (FFIEC), we participate with the other agencies in ongoing efforts to improve the analytical reports produced using HMDA data. For example, by the end of this year, our examiners will have on-line access to analytical tables developed in cooperation

with the other agencies. We are equally concerned with making the data collected under the CRA reform package useful to examiners in assessing an institution's CRA performance. We have automated data systems experts and policy analysts participating in an interagency working group to address these issues, as discussed further in our response to question 3, below.

In addition, several other interagency initiatives are underway to prepare for the work that lies ahead. We are currently developing examination procedures based on the proposal, recognizing that there may be changes prior to the promulgation of a final regulation. We also intend to provide intensive training for our examiners on the CRA reform package, the new examination procedures, and the analytical tools available to them for more efficient workload management.

We will discuss the issue of examiner workload with the GAO and determine if they identified any problems specific to OTS. If so, we will make any necessary adjustments to our examination program.

When our review of the comment letters is complete and we develop a clearer picture of the final reform package, we will be in a better position to determine if additional resources will be necessary to carry out our regulatory responsibilities, and we will respond accordingly.

3. **For larger institutions (over $250 million in assets), new data on small business, small farm, and consumer loan applications will be required. Currently the error rate for HMDA data reported by institutions is estimated to be as high as 30-40%. What procedures will the agencies put in place to check the accuracy of the new data collected from larger lenders? Would you agree that unverified data is of little practical use?**

   In a related matter, how useful will this data be if it is not broken down by gender and by race, as is now required for HMDA data?

Errors can occur at many stages in the HMDA data collection process. For example, there may be data entry errors on loan application forms, errors or omissions in transferring information from all loan applications to the Loan Application Register ("LAR"), and errors in transmitting the LAR data to the regulatory agency. We have several procedures in place to detect and correct these errors. For example, we apply electronic edits developed by the FFIEC to detect and correct incomplete or inconsistent entries, and we do not transmit the HMDA data to the FFIEC until all errors are resolved. FFIEC edits are enhanced each year to increase their effectiveness in identifying incorrect data. In addition, our examiners compare

application files with LAR entries representing those files. If they find significant errors, the institution is instructed to correct and resubmit its LAR.

We continue to review our procedures to further improve HMDA accuracy. We have established an interagency working group consisting of automated data systems experts and policy analysts to address these concerns. Many of its members have intimate knowledge of HMDA and its shortcomings. We hope to apply the lessons that we have learned from HMDA to create a CRA data collection process that will be efficient, reliable, and useful. The working group will recommend ways to structure the system and to verify the accuracy of information collected.

The information that the agencies propose to collect regarding loans to small businesses, small farms and consumer loans will be useful in determining whether such loans are being made in low- and moderate-income areas of the community. This information is not currently collected, but is directly relevant to CRA performance. We would not, however, be able to draw any inferences about race or sex discrimination from the data that we propose to collect. We appreciate that members of the Subcommittee and other members of Congress who have written us would like to see the agencies expand the data collection to include race and gender. We will review this matter with the other agencies prior to finalizing the CRA regulation.

4. **Smaller banks have complained that the 60% loan-to-deposit ratio included in the "small bank test" is unfair, since some institutions just don't make a lot of loans. Could you describe how you arrived at the 60% figure? What othar options did you consider as a test? Please be specific.**

The proposal sets forth criteria under which small institutions can avail themselves of streamlined examination procedures. One criteria is a "reasonable" loan-to-deposit ratio. The agencies indicate that a 60 percent loan-to-deposit ratio is presumed to be reasonable. The agencies' intent was to provide guidance on what we would presumptively consider fair and reasonable to account for the varying portfolios of the institutions regulated by each agency. Our intent was not to preclude an institution from rebutting the presumption, or to establish an inflexible maxim.

The agencies believe that the 60 percent figure would reduce uncertainty for roughly half of the smaller institutions that have loan-to-deposit ratios that meet or exceed the threshold. For the thrift industry in particular, our data suggests that smaller thrifts tend to meet the reasonableness standard. At the same time, we do not believe that the 60 percent ratio would disadvantage an institution with a ratio below that level. An institution with a lower ratio would need to have a reasonable loan-to-deposit ratio given its size, its

financial condition, and the credit needs of its community. An institution in a community where there is insufficient loan demand to reach a 60 percent ratio would only need to have a ratio that is reasonable given the level of demand.

Nonetheless, a number of the comment letters we have received raised the 60 percent figure as an issue. Even thrifts who meet that figure have raised concerns about the composition of the lending that will qualify toward meeting the loan-to-deposit ratio. This indicates to us that many aspects of this part of the proposal will need to be clarified or adjusted in the final regulation.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

March 24, 1994

Honorable Joseph P. Kennedy II
Chairman
Subcommittee on Consumer Credit
and Insurance
Committee on Banking,
Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We are pleased to enclose responses to your questions following-up on our testimony of February 8, 1994.

Please let us know if you have any further questions.

Sincerely,

Andrew C. Hove, Jr.
Acting Chairman

Enclosure

Responses to Questions Posed by Chairman Kennedy

Q.1. Would you please describe the rationale for allowing a lender who has received a very poor grade in the lending test to "bump up" its composite CRA rating by as many as two grades?

Couldn't lenders who do almost no lending in low- and moderate-income areas end up receiving a "satisfactory" or "outstanding" CRA rating if they choose to make an investment considered to merit an "outstanding" rating?

A.1. The rationale for allowing an institution to obtain a higher composite CRA rating by using its investments was to encourage institutions to engage in community development activities that benefit low- and moderate-income communities. An institution whose performance under the "Investment Test" is rated as "Outstanding" would have its "base rating," as determined under the "Lending Test," raised by two levels on the five-level scale. Therefore, it would not be possible for an institution with a base rating of "substantial non-compliance" to get an "outstanding" composite rating, although it would be possible for an institution with a base rating of "substantial non-compliance" to get a "satisfactory" composite rating and for an institution with a base rating of "needs to improve" to get an "outstanding" composite rating.

It is significant that the focus of the "Investment Test" would be the effect the investment has on the community as well as the amount of the investment. The regulatory agencies may adjust an institution's rating under the "Investment Test" -- either an increase or a decrease -- after taking into account whether its investments are particularly innovative, meet a special need, or involve partnerships with community development organizations.

In some distressed communities, there is insufficient loan demand, but there also are unmet credit needs. To fulfill a particular credit need, often it is necessary for an institution to invest in or to nurture projects that may not result in loans being made for several years. For example, a financial institution might invest "seed money" in a community development corporation that wants to provide affordable single-family housing to low- and moderate-income persons. The actual mortgage loans to individuals to purchase homes may be three or four years away. Community support must be generated, community leaders identified, public-private partnerships created for financing, land acquired, contractors found, potential purchasers identified and counseled -- an extraordinary amount of effort expended over a long period of time, without generating loans during this time. We believe that institutions should receive appropriate consideration for such long-term commitment.

We appreciate your concern that institutions which are not otherwise helping to meet the needs of their communities might be able to have investments compensate for inadequate performance. However, this is not what is intended. We believe the proposal provides us with the needed flexibility to recognize not only the dollar amount of investments in the community but also the institution's commitment to the community. An institution would have to demonstrate performance and commitment. It is unlikely that "an investment," as indicated in your example, would warrant an "outstanding" rating under the "Investment Test."

Q.2. The General Accounting Office has questioned the capacity of examiners to take on the workload anticipated as a result of the proposed regulations. They point out that while new data will be provided by larger banks, many examiners do not now use the Home Mortgage Disclosure Act (HMDA) data supplied by lenders because they do not have the time.

What steps have been taken by your agency to anticipate the increased workload for examiners?

A.2. There are now approximately 300 compliance examiner positions at the FDIC compared with 150 when the Compliance Examination Program was implemented in 1990. Each Region also maintains a separate Compliance Examination Review staff with specific responsibility for the compliance and fair lending examination function. We are committed to adding additional examiner and review staff positions as needed.

The FDIC also has improved its management capacity for compliance supervision. An Assistant Regional Director in each of the eight regions of the Division of Supervision has been dedicated solely to the management of the compliance and fair lending function. Until now, Assistant Regional Directors managing this function also had other responsibilities.

In addition, improved examination tools are being made available to examiners so they can conduct more thorough and efficient examinations. For example, newly developed HMDA Analysis Reports customized for each institution and specific geographic area are being provided for regional and field office use. HMDA Examination Tables summarizing an institution's reported data and designed to assist examiners in studying the data were recently installed on easily accessible computer networks in each Region. Complete 1992 HMDA Disclosure reports for all reporting institutions are available on CD ROM to examiners. Census Tract Maps and CD ROMs with census tract level demographic data have been purchased from the Bureau of the Census and are now in use to assist examiners in forming judgments on an institution's lending patterns across racial, ethnic and economic areas in each locality. Other related products have been developed including a series of Wide Area Census Tract Profiles.

Finally, the Office of Consumer Affairs has expanded the Community Affairs staff in each Region to include a Fair Lending Specialist. The Community Affairs staff serve as liaison between community groups, lenders and the FDIC on the fair lending process. They are also a resource for compliance examiners on matters concerning HMDA data analysis, lending discrimination and community development.

Q.3. For larger institutions (those with over $250 million in assets), new data on small business, small farm, and consumer loan applications will be required.

Currently the error rate for HMDA data reported by institutions is estimated to be as high as 30-40%.

What procedures will the new agencies put in place to check the accuracy of the new data collected from larger lenders? Would you agree that unverified data is of little practical use?

In a related matter, how useful will this data be if it is not broken down by gender and by race, as is now required for HMDA data?

A.3. We recognize the importance of accurate data collection and have established an interagency working group to address this issue. The working group will seek to assure that the system we establish for collecting loan data will enable examiners to verify the accuracy of the data during an examination <u>and</u> that there are built in mechanisms for automatic detection of some of the more common errors at the point of data collection and data entry. Many of the staff assigned to this group have been extensively involved with the HMDA data collection process. We believe that we can use the lessons we have learned in collecting HMDA data to create a reliable and useful CRA data collection process.

With respect to the usefulness of the data if it does not contain gender and race, the Community Reinvestment Act and the proposed CRA regulations focus on lending geographically, including to low- and moderate-income areas. Under the proposal, the agencies would evaluate the record of large institutions by analyzing their market share of all reportable loans and of reportable loans in low- and moderate-income areas. Reporting of loan data by census tract without reporting gender and race should be sufficient to evaluate these types of market share. We understand that there also is concern that we be able to use the data to identify possible lending discrimination. While we can formulate some assumptions by pairing the reported data with certain demographic information available from other sources, we would not be able to use the data to identify specific applications or even trends where there may be possible lending discrimination. We have received numerous comments urging us to expand the data collection requirements, and we certainly will review the matter with the other agencies before finalizing the CRA regulation.

Q.4. Smaller banks have complained that the 60% loan-to-deposit ratio included in the "small bank test" is unfair, since some institutions just don't make a lot of loans.

Could you describe how you arrived at the 60% figure? What other options did you consider as a test? Please be specific.

A.4. There appears to be considerable misunderstanding regarding the 60 percent loan-to-deposit ratio cited in the proposal. The proposed regulation sets forth criteria under which small institutions can avail themselves of streamlined examination procedures. One criteria is a "reasonable" loan-to-deposit ratio. The proposed regulation indicates that a 60 percent loan-to-deposit ratio is presumed to be reasonable. It is not, however, a hard and fast rule. A 60 percent ratio may not be appropriate in all cases. Our intent was to provide guidance as to what we would presumptively consider fair and reasonable to account for varying portfolios of the institutions regulated by each agency. The 60 percent figure would reduce the uncertainty for approximately half of the institutions that would be eligible for the small bank assessment method. Formulas or ratios applied across the board without respect to the differences of communities or markets may result in standards that are unfair to many institutions. The proposed regulation would allow examiners to make justifiable exceptions where the loan-to-deposit ratio does not make adequate allowance for individual circumstances. We have, however, received a substantial number of comments concerning this part of the proposal indicating that additional clarification or adjustments may be needed in the final regulation.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LAWRENCE B. LINDSEY
MEMBER OF THE BOARD

March 22, 1994

The Honorable Joseph P. Kennedy, II
Chairman
Subcommittee on Consumer Credit
and Insurance
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I appreciated the opportunity to testify before your subcommittee last month regarding the interagency regulatory proposal to reform CRA. Obviously, this is a matter of great interest to all of us and one which requires that we get it right. Your February 28 letter poses some follow-up questions that I will answer as best I can, taking into account the fact that we are still receiving, and will be analyzing, the public comments on the proposal in order to decide whether, and how, to revise the proposal.

Your first question raises the issue of whether the proposal strikes the right balance in the rating system between the lending an institution does (or does not do), and the investments in intermediaries that serve low- and moderate-income areas that it chooses to make. In particular, you ask whether an institution that does little or no lending in the low- and moderate-income portions of its service areas should be able to achieve a two-step "bump up" of its lending rating, perhaps even to an overall "outstanding" level, even if its lending record is considered less than satisfactory.

Since the proposal was issued in December, I've heard your question postulated more directly, particularly by community advocacy groups, in the vein of, "Why should a bank with a poor lending record be permitted to 'buy' an overall good rating by issuing a check and making an investment in a third party service provider?" Since I was personally very deeply involved in preparing this proposal, I can assure you that it was not the purpose of the drafters to do such a thing. In fact, there was a good deal of debate about the relative weight that would be appropriate to give lending and investments. In the end, however, it was decided that the potential for a significant

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increase to the lending rating was warranted by a significant quantity or quality of investments in third parties that make loans, and provide other needed credit related services, in low- and moderate-income areas.

I cannot speak definitively as to why others in the agencies reached that conclusion. For myself I reached that conclusion based on my belief that, since CRA's inception, such investments and the intermediaries they benefitted, have served the purposes of getting loans and other community economic development activity into low- and moderate-income areas in very significant ways. The recipients of these investments have frequently been the experts on the needs of the community being served and the methods for serving them. In that respect, they have been important partners to the lending community as it sought ways to meet its responsibilities under the law.

It may be that we have missed the mark in assigning relative weights to the two rating elements. I expect that this issue will be an important one in the public comments on the proposal. I am very willing even eager, to learn from those comments and if necessary adjust the relative weights assigned to the rating elements I strongly suspect that my colleagues in this effort are willing to do so as well.

Your second question refers to a comment on the proposal prepared by the General Accounting Office which questioned whether the agencies have the examination ability to deal with the increased workload in their examination programs that the GAO believes this proposal will entail. In particular, you indicate that the GAO believed that, while the proposal would supply more data for the examiners regarding an institution's lending, many examiners do not now use the Home Mortgage Disclosure Act data presently available due to a lack of time. You ask what steps have been taken to anticipate the increased workload.

Since the examination workload increase will result from a combination of the requirements of the final regulation and any resulting examination procedures, it would be premature for us to try to anticipate, with any reliable degree of precision, how to adjust our resources to deal with it. The agencies have however, begun a process of planning for a computerized system to collect, analyze, and disseminate any data required by the final regulation to be collected. In doing this, we are able to learn from the HMDA data analysis system we have developed over the past few years and to which our examiners have on-line access.

That system produces a set of standard analytical reports and also enables our examiners to get answers to questions they have tailored to the examination they are conducting. This system has proven to be very useful to our examiners (it is available to all of the agencies examiners) and is used routinely by them We hope that by producing a similar system using any data collected for the purposes of the new CRA regulation we will minimize the examination burden while maximizing its effectiveness. Nonetheless should the final regulation and examination procedures, for whatever reason unduly tax our ability to maintain an effective examination program with present resource levels, we will do what is necessary, quickly, to rectify the situation.

Your third question raises several issues relating to the data to be collected under the proposal by larger institutions regarding their lending to small businesses and consumers. First, you ask what procedures the agencies will put in place to verify the accuracy of the data Second you ask how useful the data will be if it is not broken down by gender and race as is presently the case under HMDA.

Regarding the first matter, I would anticipate that the data collection system discussed in my preceding answer will include significant edit procedures to assure that the data being put into the system is accurately entered on any collection forms or software. In fact, it may be that the agencies will be able to issue to lenders collection software that contains the necessary edits thereby enabling them to check the data at the source. These edit procedures in the computerized collection system would, of course, only assure that the data are consistent with the data entry regimen, e.g., that any census tract entered is validly denominated, and the like. They cannot ensure that any particular data element is, in fact, accurate. That can only be done by examiners checking the records on site during the examination.

As is the case with the HMDA data, I would anticipate that any examination procedures that are prepared to guide the examination process will include procedures to verify the data's accuracy. Given the size of the data base, it is obvious that such verification would have to be done by use of a sampling technique. It seems to me that, given the importance of the data to everyone involved--the institutions, the examiners, and the communities--under the market share test of the proposal, the accuracy of the data is a top priority.

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The second major issue you raise in your third question is an important one. It involves serious considerations about the purposes for which the data are collected and the costs of that collection. As I understand CRA, its purpose is to assure that insured depository institutions help meet the credit needs of their entire communities, including the low- and moderate-income areas of those communities. It seems clear to me from my understanding of the law that the operative component of that formulation is geographic. If I am correct in that, it seems to me that the type of geographically based data called for by the proposal is appropriate to the task. Collecting data on the race and gender of applicants does not seem necessary for such a purpose and requiring institutions to do so in a regulation promulgated under the auspices of CRA may be a bit of a stretch.

I am sensitive to the arguments regarding the need for data concerning possible lending discrimination that this issue involves. I am also aware of the fact that when the President asked the agencies to reform CRA last July, he indicated that our efforts should balance a number of factors, including the need to reduce regulatory burden and documentation requirements. Requiring institutions to report aggregate data that demonstrates the geographic character of their lending rather than more applicant-specific data, seems to be responsive to that element of the President's concerns. Being mindful of this need for sometimes delicate balancing of interests, the agencies drafted the proposal in the way we have discussed. But I have no doubt that this will be a major issue in the public comments and I look forward to being informed by them. This issue, like the others you raise, is certainly still open given that we are still in the comment-seeking phase of the reform effort.

Your final question deals with the matter of the 60 percent loan to deposit ratio included in the "small bank test." You indicate that some small banks have opined that the 60 percent test is unfair because some institutions do not make many loans. You asked how the 60 percent figure was derived, and asked what other options were considered. First, I would emphasize that <u>a 60 percent loan to deposit ratio is not a requirement</u> to receive the fully streamlined small bank examination treatment provided by the proposal. What is required under the proposal for such treatment <u>is a reasonable loan to deposit ratio</u>. The 60 percent figure, though misunderstood by many, and, perhaps, poorly explained by the agencies, was placed in the proposal as a presumptively reasonable loan to deposit ratio merely in order to supply certainty to institutions that meet that level of lending. It was not designed to be a floor or a ceiling, or even a requirement.

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Small institutions who do not meet the 60 percent level can still be deemed to have a reasonable loan to deposit ratio. The reasonableness of any particular institution's ratio will have to be determined on a case-by-case basis, taking into account local economic conditions, loan demand in the area, the loan to deposit ratios of other depository institutions in the area and the like.

The arguments put forward to justify the streamlined examination treatment of small institutions included the notion that small banks, especially those located in small towns, by their very nature must be making loans in their communities, thereby meeting CRA's main objective. If they weren't, it has been argued, they would not be in business. By requiring that the institution have a reasonable loan to deposit ratio, a good loan mix, the majority of its loans in its community, and, if it is a HMDA reporter, a good distribution of those loans (three of the other tests for fully streamlined examination treatment contained in the proposal) the proposal puts that justification to the test.

The 60 percent presumptive standard was reached, in my view, more by an exercise of judgment than science. We wanted a standard that had some rigor, but one that also afforded a significant number of small institutions the certainty intended. At the 60 percent level, using current data we estimate that approximately 50 percent of the banks that fall into the small institution asset size category will be able to take advantage of the presumption. That seemed about right, but, again, I hope to be guided on the correctness of that judgment by the public comments. I would add that, even if an institution does not meet one of the criteria for fully streamlined examination treatment, the only consequence is that it would be examined more closely. The proposal would not force it into the more general approach afforded larger institutions involving data collection and a review of its lending, investments, and services.

I trust that this has been responsive to your interests and concerns. Please contact me if I can be of further assistance.

Sincerely,

Lawrence B. Lindsey

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